ISLAMIC CAPITAL MARKET FACT FINDING REPORT

OICV-IOSCO

REPORT OF THE ISLAMIC CAPITAL MARKET TASK FORCE OF THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

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Chapter 1: Introduction

There is no doubt that securities markets and products continue to evolve and change. The challenge to regulators is to consistently be abreast of and track new market developments in order for there to be effective and timely formulation of standards, guidance or best practices where necessary. Numerous international initiatives completed in the last few years focused on assessing weaknesses in the international financial markets and analysing the operations of markets in order to develop global standards and benchmarks that have the ultimate aim of strengthening the international financial architecture. This report aims to contribute to the process of building knowledge with the goal of achieving the objectives of improving investor protection; ensuring that markets are fair, efficient and transparent; and reducing systemic risk, as set out in IOSCO's *Objectives and Principles of Securities Regulation*, which is one of the internationally accepted standards listed in the Financial Stability Forum's Compendium of Standards.

The Islamic financial services industry, comprising Islamic banking, Islamic insurance (takaful) and the Islamic capital market, is an area that has grown to become an increasingly substantial segment within the global financial market and has gained considerable interest as a viable and efficient alternative model of financial intermediation. Growing awareness of and demand for investing in accordance with *Shariah* principles on a global scale have been the catalyst towards making the Islamic financial services industry a flourishing industry. This is also a reflection of the increasing wealth and capacity of investors, both Muslim and non-Muslim, to seek and invest in new investment products that serve their needs.

Islamic financial products also represent a class of investment products, which may appeal to those looking for socially responsible or ethical investments, as these products must comply with strict *Shariah* rules that have religious as well as ethical underpinnings. Indeed, the pace of Islamic financial market development has gathered such momentum that various international Islamic organisations have been established with the view towards formulating appropriate standards for the Islamic financial services industry. These international bodies include the Islamic Financial

Services Board (IFSB)[1] and the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI).

In recognition of the increasing size of, and growing investor interest in the Islamic financial services industry, and the potential implications it may have on financial stability and investor protection, the IOSCO Executive Committee, at the 2002 IOSCO annual conference and meetings held in Istanbul, Turkey, mandated the formation of an Islamic Capital Market Task Force to assist relevant regulators in assessing the extent of the development and potential regulatory issues relating to the Islamic capital market, as well as to gather information on Islamic financial products and activities. The output expected from the Task Force is an information document that would detail the landscape of the Islamic financial services industry in general, and would highlight key issues concerning the Islamic capital market in particular. While Islamic banking is the most developed part of the Islamic financial system, there is great potential for the Islamic capital market as the industry matures and holdings of financial assets gradually transfer from the Islamic banking sector to the Islamic capital market. As has been the experience with nascent fast-growing markets, various regulatory issues need to be assessed on a timely basis. This mandate represents an important initiative taken by capital market regulators to study the area of the Islamic capital market in order to gain a better understanding of its specific attributes. This is to ensure that the Islamic capital market is appropriately regulated and that any gaps in regulation are identified early to safeguard investor interest and at the same time pave the way for the industry to evolve in an orderly manner.

The Task Force comprises 11 IOSCO members spread across 5 regions. The Task Force is chaired by the Securities Commission of Malaysia. (Please refer to Annex 1 for details of Task Force members).

The work of the Task Force is built on gathering information from among IOSCO members and external parties with expertise in the Islamic capital market, and to undertake an in-depth analysis of the information obtained. A survey questionnaire was formulated to seek information pertaining to the following broad issues – (i) the

[1] The establishment of the IFSB in November 2002 was supported by the International Monetary Fund.

overall availability of Islamic financial and capital market products and services; (ii) the regulatory framework applied to Islamic financial services and products, and issues pertaining to *Shariah* compliance and investor protection; (iii) the state of Islamic capital market development including an examination of growth factors and impediments; (iv) market foundations such as accounting standards and tax frameworks; and (v) international issues relating to cooperation and collaboration efforts among jurisdictions, as well as efforts to address differing *Shariah* interpretations among scholars. In the course of its work, the Task Force also conducted extensive research and teleconference interviews with selected industry participants in order to be able to present as wide a discussion on this topic as possible.

In this report, the Task Force presents the information collated from the surveys. In addition, the report also identifies key issues that affect the development and regulation of the Islamic capital market. These key issues were identified within the context of IOSCO's overarching objectives of investor protection; ensuring that markets are fair, efficient and transparent; and the reduction of systemic risk. In connection with this, the report has also discussed the application of the *IOSCO Objectives and Principles* of Securities Regulation (IOSCO Principles) in relation to the Islamic capital market. In this regard, it is important to bear in mind that IOSCO, as an organization with members from over 100 jurisdictions, is a secular organization. Each IOSCO member has committed to making best efforts to implement the IOSCO Principles within its jurisdiction whatever the religious or other precepts that may be observed there. Individual members are free, however, to implement the IOSCO Principles within the context of their own culture and society and IOSCO recognizes that many of its members have an interest in the development of Islamic capital markets. While IOSCO has no view regarding compliance with religious or other precepts beyond the matters of regulatory policy set out in its principles, IOSCO is the recognized international standard setter and places great importance on furthering the application of the IOSCO Principles in the context of the development of Islamic capital markets.

The report is structured as follows:

Chapter 1 introduces the background to the conception of the report and the establishment of the Task Force.

Chapter 2 explains the fundamentals and principles underlying Islamic finance. It discusses the philosophy and beliefs, which have led to the structuring of *Shariah* -compliant financial products and services.

Chapter 3 describes the landscape of the Islamic financial services industry with discussions on the individual components which make up the Islamic financial services industry – Islamic banking, Islamic insurance (takaful) and Islamic capital market. The discussions trace the history of the Islamic financial services industry and maps out the geographical spread of Islamic financial activities, discusses the product range as well as structures. The background of various international Islamic organisations and their respective roles and objectives are also discussed.

Chapter 4 discusses the developmental and regulatory issues that have arisen out of the Task Force's survey and research. Among the key issues discussed are *Shariah* compliance, the applicability of the conventional regulatory framework to the Islamic capital market including the IOSCO Principles, accounting standards and international collaboration efforts.

Chapter 5 concludes the report. It recognizes the potential growth of the Islamic capital market, and discusses the importance of jurisdictions' compliance with IOSCO's Objectives and Principles in relation to the Islamic capital market.

The report has four annexes. Annex 1 lists the members of the Task Force while Annex 2 provides a glossary of Islamic terms. Annex 3 lists the respondents to the survey and the bibliography is contained in Annex 4.

Pursuant to its mandate, the Task Force has not formulated any specific recommendations within this report. The objective of this report has been to present factual and background information, and to raise concerns and issues arising from the survey and from the Task Force's own extensive research. In addition, this report may perhaps serve as a useful document that could be utilized in future efforts.

Chapter 2: Fundamentals and principles of Islamic finance

2.1 Introduction

The Islamic financial system broadly refers to financial market transactions, operations and services that comply with Islamic rules, principles and codes of practices. The laws and rules of the religion require certain types of activities, risks or rewards to be either prohibited or promoted. While Muslims undertaking financial transactions are encouraged to use financial instruments that comply with these rules, other investors may find the appeal of these instruments from an ethical standpoint.

Islamic laws and rules are known as *Shariah* and are also referred to as Islamic jurisprudence. *Shariah* governs all aspects of Islamic matters including faith, worship, economic, social, political and cultural aspects of Islamic societies. The rules and laws are derived from three important sources, namely the Holy *Quran* (the holy book of the religion of Islam), *Sunnah* (the practice and tradition of the Prophet Muhammad s.a.w.) and *ijtihad* (the reasoning of qualified scholars). Further elaboration and interpretation of the rules dictated by the Holy *Quran* and *Sunnah* are provided by qualified scholars in Islamic jurisprudence via *ijtihad* or an interpretative process which is carried out within the framework of *Quran* and *Sunnah*.

Modern Islamic financial products and services are developed using two different approaches. The first approach is by identifying existing conventional products and services that are generally acceptable to Islam, and modifying as well as removing any prohibited elements so that they are able to comply with *Shariah* principles. The second approach involves the application of various *Shariah* principles to facilitate the origination and innovation of new products and services.

In order to provide a better understanding on the unique attributes of Islamic finance, this Chapter discusses the fundamentals and principles, which form the foundation of Islamic financial services.

2.2 Fundamentals of Islamic finance

Islamic law on commerce is known as *fiqh al-mu`amalat*. Much of the laws, rules and interpretations of *Shariah* takes into consideration issues of social justice, equitability, and fairness as well as practicality of financial transactions. In general, the *Shariah* legal maxim in relation to commercial transactions and contracts state, "they are permissible unless there is a clear prohibition."[2] In a nutshell, prohibited elements of a commercial transaction must first be removed for it to be *Shariah*-compliant. The major prohibited elements under *Shariah* are *riba* (interest), *gharar* (uncertainty), *maisir* (gambling), non-*halal* (prohibited) food and drinks and immoral activities. These are elaborated further below.

a) *Prohibition of riba*

Riba has the literal meaning of "an excess" and is defined as an increase or excess which accrues to the owner in an exchange or sale of a commodity, or, by virtue of a loan arrangement, without providing equivalent value to the other party.

More precisely there are two categories of *riba* – *riba qurudh* and *riba buyu`*. *Riba qurudh,* in its application to modern financial transactions, occurs through loans. The prohibition of *riba qurudh* relates to any fixed or pre-determined rate of return tied to the maturity and the amount of principal (i.e., guaranteed regardless of the performance of the investment). The general consensus among *Shariah* scholars is that *riba* covers not only usury but also the charging of "interest" as widely practised.

However, the lending activities or loans are still allowed in Islam through the concept of *Qardh Hasan.* This type of lending is a contract of loan between two parties on the basis of social welfare or to fulfil a short-term financial need of the borrower. The amount of repayment must be equivalent to the

[2] Mohammad Hashim Kamali (Prof.Dr), *Islamic Commercial Law*, Cambridge: The Islamic Texts Society, 2000, p.66; Yusuf al-Qaradawi (Prof.Dr.), *The Lawful And The Prohibited In Islam*, Kuala Lumpur: Islamic Book Trust, 1985, p. 14

amount borrowed. It is however legitimate for a borrower to pay more than the amount borrowed as long as it is not stated or agreed at the point of contract.

On the other hand, *riba buyu`* occurs through the sale and purchase of six *riba*'s commodities (i.e., gold, silver, dates, wheat, barley and salt). The transaction of *riba's* commodities is required to adhere to the following conditions:

a) In trading commodities of the same group and kind, such as gold for gold or dates for dates; two conditions must be fulfilled, i.e., both commodities must be exactly equivalent and there must be prompt delivery
b) In trading commodities of the same group but of different kinds, such as gold for silver, or wheat for barley, there is only one condition, i.e., the promptness in delivery is not a condition.
c) In trading commodities of different groups and kinds, such as gold for wheat, or silver for barley; no condition is imposed and free trading can exist, whether there is equality, inequality, promptness or delay.

Thus, Islam encourages the earning of profits but forbids the charging of interest. Profit symbolises successful entrepreneurship and the creation of additional wealth through the utilisation of productive assets, whereas interest is deemed as a cost that is accrued irrespective of the outcome of business operations and may not create wealth if there are business losses. Social justice under *Shariah* requires borrowers and lenders to share rewards as well as losses equitably and that the process of wealth accumulation and distribution in the economy be fair and representative of true productivity.

b) *Prohibition of activities with elements of gharar (uncertainty)*

Gharar is defined as activities that have elements of uncertainty, ambiguity or deception. In a commercial transaction, it refers to either the uncertainty of the goods or price of goods, or deceiving the buyer on the price of goods.

An element of *gharar* is considered a normal phenomenon in the market if it is not excessive in the contracts and where the effect on the economy and society is considered minimal. This is accepted by *Shariah* as it would be practically impossible to eradicate this element completely from the market. A large element of *gharar* in a commercial transaction, on the other hand, is prohibited according to *Shariah* as it may affect the legality of a transaction.

One of the examples of *gharar* in the financial market is in conventional insurance. *Shariah* scholars are of the opinion that conventional insurance is not *Shariah* compliant due to the large element of *gharar*. This is because the policyholder enters into an agreement to pay a certain sum of premium and in turn the insurance company guarantees to pay a certain sum of compensation in the event of disaster. However, the amount of compensation that the company will pay to them is uncertain and it is also dependant on the occurrence of specific events in the future.

c) *Prohibition of maisir (gambling) activities*

Gambling is referred to as *qimar* or *maisir* in Arabic, which means any activity that involves an arrangement between two or more parties, each of whom undertakes the risk of a loss where a loss for one means a gain for the other, as it is common for gambling activities. The gain accruing from these games is unlawful in Islam, as it diverts the player's attention from productive occupation, and amassing wealth without effort. It is considered an immoral inducement by the person involved in expecting to make a profit at the expense of another party.

In relation to the above, Muslims are also prohibited from having any affiliation to gambling activities including participating, investing or financing any businesses related to, or associated with, the gambling industry.

d) ***Prohibition of the production and sale of goods and services that are prohibited in Islam***

There are a number of drinks and foods that are prohibited in Islam such as alcoholic beverages and non-permissible food like pork. In addition, there are also prohibitions against immoral services such as pornography, prostitution, immoral entertainment and others. In this context, *Shariah* scholars are of the view that any activity relating to these products and services such as processing, producing, marketing, supplying and selling are also non-permissible.

Therefore, companies, which are involved in or accrue gains from business activities related to these non-permissible activities, would not be deemed as *Shariah* compliant.

2.3 Basic *Shariah* principles for Islamic financial products and services

The underlying fundamentals of Islamic financial transactions form the basis of the difference between conventional and Islamic financial instruments. Modern Islamic finance began with the emergence of Islamic banking, where products and services are not based on *riba* (interest). As the industry grew, many other financial products in the insurance and capital market sectors were adapted to incorporate *Shariah* compliant aspects. Product innovation has been significant in the Islamic financial services industry over the last decade, resulting in a wide array of Islamic instruments being introduced in the market. *Shariah* compliance rules have been developed for equity, debt and securitisation products and are in the process of being extended to structured products and examined for derivatives as well. Rules to determine Islamic-compliant operations have also been developed for the banking, broking, investment management and advisory services.

Islamic equity financing represents a component of the overall capital market activity. Typically, equity-financing is structured through profit-sharing contracts or *`uqud al-isytirak.* The two common types of equity financing instruments are *mudharabah* (profit-sharing) and *musharakah* (profit and loss sharing)**.**

Significant differences, however, occur in the area of debt-financing due to the fact that conventional debt-financing is essentially structured upon interest-based lending. Islamic debt-financing is structured through contemporaneous underlying contracts of exchange such as sale and purchase contracts or *`uqud al-mu'awadat*. There must be an underlying asset which is made the subject matter of the contract in Islamic financing as opposed to a mere debt paper in conventional financing. Common *Shariah* principles that are used in Islamic debt instruments include *murabahah* (trade with mark up or cost plus), *ijarah* (lease financing), *bai` al-salam* (advance purchase), *istisna`* (purchase order) and others. Similarities with the conventional market also exist in *ijarah*, whereby *Shariah* recognises the different types of leasing such as an operating lease and a finance lease, as long as the aim of the lease is *Shariah*-compliant.

In developing these products, the basic elements of *Shariah* principles, as provided for in the section above, are applied. The following section will now consider the types of *Shariah* principles that are widely used in the Islamic finance currently. They have been used and developed in structuring various Islamic financial products and instruments for banking, capital market and insurance sectors.

a) *Mudharabah* (Profit-sharing)

One of the most important *Shariah* principles for investment activities is *mudharabah*, also known as *qirad* or *muqaradah*. It offers the owner of capital the opportunity to invest his capital in a certain project without becoming involved in managing that capital, and limits his liabilities to the capital committed. There is also an entrepreneur, who solely manages the projects. The most important feature of *mudharabah* is that the capital provider cannot claim a fixed profit and an assured return of his capital if the project is profitable, as the profit will be distributed based on a pre-agreed ratio between the capital provider and the entrepreneur. In the event of a business loss, it shall be borne solely by the capital provider and none on the part of the entrepreneur, unless the loss is due to negligence of the entrepreneur.

In addition, *Shariah* scholars have evolved the *mudharabah* principle further by introducing a "two-tier *mudharabah*." The first tier *mudharabah* is created when the investor or capital provider places his capital with an Islamic financial institution which acts as the entrepreneur. The financial institution in turn invests the capital with another entrepreneur by means of a second-tier *mudharabah*. In other words, by using this type of *mudharabah*, an Islamic financial institution can act as an intermediary between investors and entrepreneurs.

b) *Musharakah* (Profit and Loss Sharing)

This is analogous to a joint venture. Both the entrepreneur and investor contribute to the capital (assets, technical and managerial expertise, working capital, etc.) of the operation in varying degrees and agree to share the returns, as well as the risks, in proportions agreed to in advance.

Shariah scholars have developed the *musharakah* principle further by introducing diminishing *musharakah* (or *musharakah mutanaqisah*), as a newly developed financial contract. Under this contract, the financial institution and client share the ownership of the financed asset. The periodic payment of the client contains two parts; a rental payment for the part of the property owned by the Islamic financial institution and a buy-out of part of that ownership. Over time, the portion of the asset owned by the client increases, until he owns the entire asset and the contract is eventually terminated.

c) *Murabahah* (Trade with mark up or cost-plus sale)

One of the most widely used instruments for short-term financing is based on the traditional notion of purchase finance. In this sale, the buyer (client) knows the price at which the seller obtains the object to be financed, and agrees to pay a premium over the initial price. It is an agreement that refers to the sale and purchase transaction for the financing of an asset or project, whereby the costs and profit margin (mark-up) are made known and agreed to by all parties

involved. As practised in the market for *murabahah* arrangements, the financier undertakes to buy the asset required by the client for resale to the client at a higher price as agreed upon by both parties and this can be settled in cash or in instalments as specified in the agreement.

d) *Bai` bithaman ajil* (Deferred-payment sale)

Bai` bithaman ajil* has similar features as *murahabah* in term of the financier undertaking to buy the asset required for resale to the client at a higher price as agreed to by the parties involved. The difference with *murahabah* is that *bai` bithaman ajil is used for long term financing and the seller is not required to disclose the profit margin which is included in the selling price.

e) *Bai` al- salam* (Advance purchase)

This is a sale and purchase transaction whereby the payment is made in cash at the point of the contract but the delivery of the asset purchased, as specified in the agreement, is deferred to a pre-determined date. In modern Islamic finance, *Shariah* scholars have allowed parallel *salam* or back to back *salam* contracts, whereby the financier will play a dual role. On one hand the financier is the seller in one *salam* purchase agreement and on the other hand he becomes a customer by entering into a separate independent *salam* agreement in order to acquire *salam* goods of a similar specification. The most important thing in the parallel *salam* is to distinguish the contracts as two separate deals of *salam.*

f) *Istisna`* (Purchase order)

This is a sale and purchase agreement whereby the seller undertakes to manufacture or construct according to the specifications given in the agreement. It is similar to *bai` salam*, the main distinction being the nature of the asset and method of payment. *Istisna`* generally covers those things which are customarily made to order and advance payment of money is not necessary as required in *bai` salam*. The method of payment in *istisna`* is flexible,

according to the terms as agreed to by the contracting parties. Parallel *istisna`* or back to back *istisna`* contracts is also permissible, similar to that of parallel *salam*, whereby the financier will play a dual role – i.e., he is the contractor in one *istisna`* purchase agreement but he becomes a customer in the other separate, independent *istisna`* sale agreement.

g) *Ijarah* (Lease financing)

Another popular instrument is leasing which is designed for financing an asset or equipment. It is a *manfaah* (benefit) or the right to use the asset or equipment. The lessor leases out an asset or equipment to the client at an agreed rental fee for a pre-determined period pursuant to the contract. Different forms of leasing are permissible, including leases where a portion of the instalment payment goes toward the final purchase at the end of the leasing period whereby the ownership of the asset or equipment will be transferred to the lessee through a sale and purchase contract. It is considered as Islamic hire-purchase or Islamic finance leasing and also known as *ijarah thumma bai`* or *ijarah wa iqtina'* or *ijarah muntahiyah bi tamlik*.

Chapter 3 : Landscape of Islamic financial services industry

3.1 Overview of the evolution of Islamic finance

3.1.1 Origins

Islamic finance has a long history and, in fact, some of the concepts and instruments commonly used today such as *mudharabah* and *musharakah* can be traced back to pre-Islamic days. After the establishment of Islam in the Middle East, Islamic principles were applied to trade financing practices then and were further formalised and institutionalised. Most of the early formal structures were developed in relation to state-based financing to aid and support business activities.

The increasing European influence during the period of colonialism resulted in the adoption of European-style financial institutions and products by most of the Islamic countries. However, by the 1960s, Islamic countries began to re-examine their financial services industry and establish financial systems compatible with *Shariah* principles. This eventually laid the ground for modern Islamic finance.

3.1.2 Modern Islamic Finance

Initial efforts to create a modern Islamic financial system took the route of replicating and adapting institutions and products in the existing conventional system. A major factor in choosing this approach was the fact that the existing legal, accounting and tax frameworks were often modelled after developed, non-Islamic financial centres.

The creation of modern Islamic financial institutions began with the establishment of Islamic banks. Its rapid growth was, to a large extent, aided by a period of prosperity for the Arab world, which benefited from rising oil prices. The huge amounts of wealth in the region provided a source of substantial liquidity for the nascent Islamic banks. As a result of its early head-start, Islamic banking is today the most developed

component in the Islamic financial system and Islamic banks represent the bulk of Islamic financial institutions worldwide.

The success in developing Islamic banking spurred efforts to extend Islamic practices into other market segments. The next significant development was the establishment of Takaful or Islamic insurance with the principles of compensation and shared responsibility among the community by using instruments that were in line with *Shariah*. In addition, Takaful also plays an important role in mobilising long-term funds, providing risk protection as well as supporting overall economic growth and development.

With the establishment of Islamic banks and takaful institutions, the management of balance sheet liquidity became a major challenge due to the scarcity of Islamic capital market instruments. Islamic banks had surplus funds to invest after providing for liquidity and statutory reserves, and financing for clients. Similarly, takaful operators faced a shortage of *Shariah*-compliant financial products in which to invest, particularly for long-term tenures. Some of these institutions' funds remained inactive because of limited investment opportunities.

It was clear that Islamic banking and takaful could not exist in isolation without the support of an Islamic capital market. Initial efforts to overcome this problem focused on creating short-term and long-term debt instruments that were in line with *Shariah* principles. This was evident, in some jurisdictions, through the issuance of diverse Islamic financial instruments ranging from short-term papers to long-term bonds to meet the liquidity and investment needs of Islamic banking and takaful institutions. It was also aimed at providing issuers with flexibility in structuring the instruments according to the specific financing requirements.

The strong growth of Islamic financing continues to be driven by increasing demand; not only by those who invest in such instruments in order to meet their religious obligations, but also by others, including non-Muslims, who find some of the risk-return features attractive, or investors who subscribe to ethical investment philosophies. Islamic finance is becoming a prominent segment of the global financial market with the most active global financial centres for Islamic financial activities

located in London and New York. Many of the global financial players such as Citigroup, HSBC and Standard Chartered, among others, have recognised the potential market demand for these products and have built their capacity and capabilities to originate, distribute and make markets in Islamic financial products.

The stages of evolution of the Islamic financial services industry are illustrated below:

Table 3.1.2-1: Stages of evolution of the Islamic financial services industry

1970s	1980s	1990s	2000s
Institutions: - Commercial Islamic banks	**Institutions:** - Commercial Islamic banks - Takaful - Islamic investment companies	**Institutions:** - Commercial Islamic banks - Takaful - Islamic investment companies - Asset management companies - Brokers/Dealers	**Institutions:** - Commercial Islamic banks - Takaful - Islamic investment companies - Islamic investment banks - Asset management companies - E-commerce - Brokers/Dealers
Products : - Commercial Islamic banking products	**Products:** - Commercial banking products - Takaful	**Products:** - Commercial banking products - Takaful - Mutual Funds / Unit trust - Islamic bonds - *Shariah*-compliant stocks - Islamic stockbroking	**Products :** - Commercial banking products - Takaful - Mutual Funds / Unit trust - Islamic bonds - *Shariah*-compliant stocks - Islamic stockbroking
Area : - Gulf / Middle East	**Area :** - Gulf / Middle East - Asia Pacific	**Area :** - Gulf / Middle East - Asia Pacific	**Area :** - Gulf / Middle East - Asia Pacific - Europe / Americas - Global Offshore Market

3.2 Components of the Islamic financial services industry

3.2.1 Islamic banking

Islamic banks today represent the majority of Islamic financial institutions, which are spread worldwide. The emergence of Islamic banking was a result of a revival of interest to develop an Islamic economic system as well as the increasing demand from Muslims worldwide for products and modes of investment that are in compliance with *Shariah* principles. The pioneering establishment of Islamic banks had been the catalyst for growth and provided the foundation for the development of the Islamic financial services industry as a whole.

In general, Islamic banks are characterised by the following features:

a. Transactions that are free from the payment and receipt of a fixed or predetermined rate of interest
b. Transactions that are based on profit and loss sharing (PLS) arrangements where the rate of return is not fixed prior to the undertaking of the transactions
c. Business activities and investments that are undertaken on the basis of permissible activities
d. Transactions that are free from elements of *gharar* (unreasonable uncertainty)
e. Payment of *Zakat* (alms or taxes) by the bank
f. Transactions that operate through *Shariah*-compliant modes of financing

Another salient feature of Islamic banks is the requirement for the establishment of *Shariah* supervisory boards. These boards are responsible for reviewing, scrutinising and endorsing the activities and operations of Islamic banks to ensure that their activities are in line with *Shariah* principles.

The funding operations are broadly divided into four main types of Islamic bank accounts – current accounts, savings accounts, investment accounts and special investment accounts. These accounts are structured under various *Shariah* principles such as *mudharabah*, *wadiah yad dhamanah* (trust account), *musharakah* and others.

Apart from funding operations, Islamic banks provide financing facilities to their customers either on a short, medium or a long-term basis in accordance with the various *Shariah* principles. In general, Islamic banks' financing activities can be divided into several types, such as project financing under the principles of *mudharabah, musharakah*, *bai` bithaman ajil* and *ijarah.*

Early experimentation with Islamic banking took the form of a savings bank that operated on a profit sharing basis in the Egyptian town of Mit Ghamr in 1963. This bank functioned more as a savings institution rather than as a commercial bank. The first recognised interest-free commercial bank was Nasser Social Bank. It was established in Cairo in 1971 with the objective of developing a social security system in Egypt.

The next milestone was the founding of the Islamic Development Bank (IDB) in 1975 under the auspices of the Organization of the Islamic Conference (OIC).[3] The main functions of the IDB was to provide assistance – in the form of equity capital and loans for *Shariah*-compliant projects – for the economic development and social progress of member countries as well as to promote Islamic banking worldwide.

The establishment of IDB was a catalyst for the establishment of Islamic banks in other Muslim countries. The Dubai Islamic Bank was incorporated immediately after the establishment of IDB in 1975. In 1977, three more Islamic banks, i.e., Faisal Islamic Bank of Egypt, Faisal Islamic Bank of Sudan and the Kuwait Finance House, commenced business. The list of Islamic banks that were incorporated in the late 1970s and early 1980s are shown in table 3.2.1-1.[4]

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[3] The Organization of the Islamic Conference (OIC) is an inter-governmental organization grouping 56 States. These States decided to pool their resources together and combine their efforts to ensure the progress and welfare of their members and those of other Muslims worldwide.

[4] See " Islamic Banking System, Concept & Applications" by Sudin Haron and Bala Shanmugam, 1997

Table 3.2.1-1: Islamic banks incorporated in the late 1970s and early 1980s

Name	Country	Date of Establishment
Nasser Social Bank	Egypt	1971
Islamic Development Bank	Saudi Arabia	1975
Dubai Islamic Bank	United Arab Emirates	1975
Faisal Islamic Bank of Egypt	Egypt	1977
Faisal Islamic Bank of Sudan	Sudan	1977
Kuwait Finance House	Kuwait	1977
Islamic Banking System International Holdings	Luxembourg	1978
Jordan Islamic Bank	Jordan	1978
Bahrain Islamic Bank	Bahrain	1979
Dar al-Mal al-Islami	Switzerland	1981
Bahrain Islamic Inv. Company	Bahrain	1981
Islamic International Bank for Investment & Development	Egypt	1981
Islamic Investment House	Jordan	1981
Al-Baraka Investment and Development Company	Saudi Arabia	1982
Saudi-Philippine Islamic Development Bank	Saudi Arabia	1982
Faisal Islamic Bank Kirbis	Turkey	1982
Bank Islam Malaysia Bhd	Malaysia	1983
Islamic Bank Bangladesh Ltd	Bangladesh	1983
Islamic Bank International	Denmark	1983
Tamadon Islamic Bank	Sudan	1983
Qatar Islamic Bank	Qatar	1983
Beit Ettamouil Saudi Tounsi	Tunisia	1984
West Sudan Islamic Bank	Sudan	1985
Albaraka Turkish Finance House	Turkey	1985
Faisal Finance Institution	Turkey	1985
Al Rajhi Company for Currency	Saudi Arabia	1985

Name	Country	Date of Establishment
Exchange & Commerce		
Al-Ameen Islamic & Financial Investment Corp. India Ltd.	India	1985

Various approaches were used towards establishing an Islamic banking system by different countries. Some countries such as Iran and Sudan converted their entire financial systems to become an interest-free system. By contrast, in the majority of countries, the Islamic banking system developed in parallel with the conventional banking system. Malaysia, Egypt and Saudi Arabia have dedicated Islamic banks, as well as conventional banks that offer banking services based on *Shariah* principles. The Islamic units of conventional banks are commonly known as "Islamic windows." These Islamic units are required to maintain separate current/ clearing accounts for their Islamic banking operations and, in some jurisdictions, they are required to appoint *Shariah* advisers to advise on the day-to-day operation of Islamic windows.

Currently, there are estimated to be over 265 Islamic banks with a market capitalisation in excess of USD 13 billion. Total assets are estimated at over USD 262 billion with financial investments above USD 400 billion. Deposits in Islamic banks are estimated to be over USD 202 billion worldwide and the average annual growth rate of the Islamic banking industry ranged between 10-20% over the past decade.[5] Tables 3.2.1-2 and 3.2.1-3 show the size of assets, deposits and financing of Islamic banking in the most active Islamic banking centres, namely Bahrain and Malaysia.

[5] See "Islamic Banking: Key Challenges Ahead" by Dr. Fouad Shaker, The World Islamic Banking Conference, 2003

Table 3.2.1-2 : Growth of Bahrain Islamic banking (1990 – 2001)

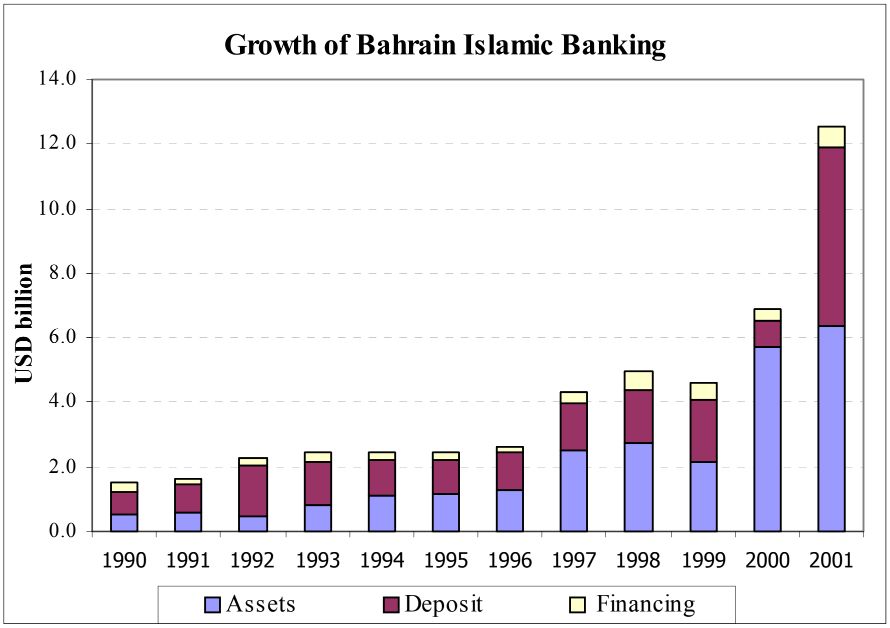
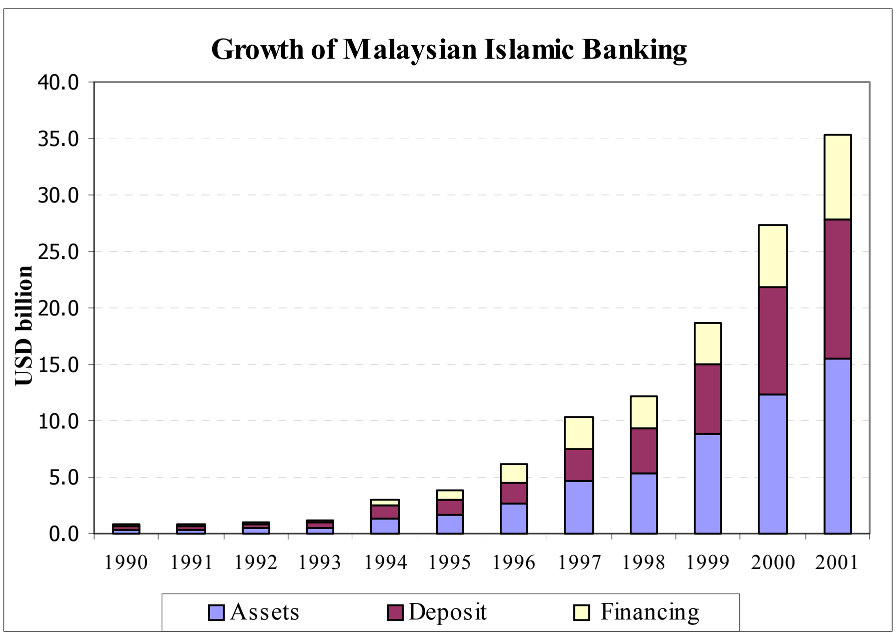


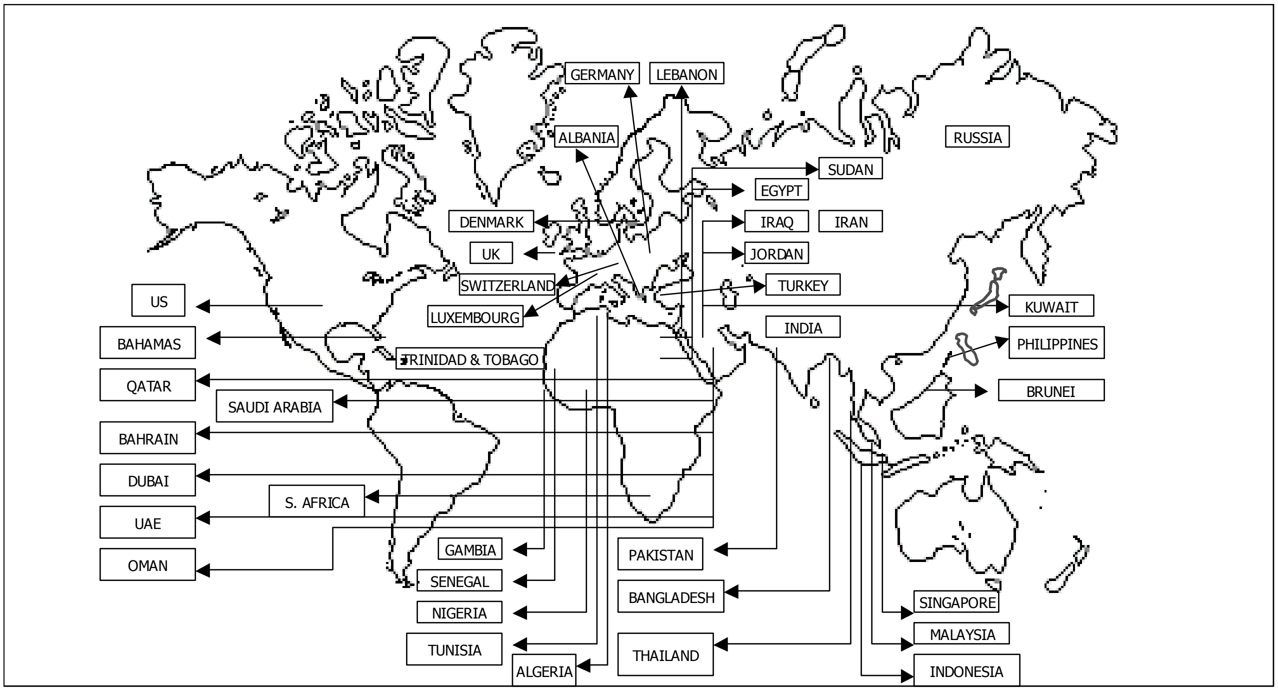
Table 3.2.1-3 : Growth of Malaysian Islamic banking (1990 – 2001)



In total, there are at least 39 countries that have already established or are offering Islamic banking products and services, as broadly illustrated in table 3.2.1-4. It is projected that the Islamic banking industry would account for at least 40 to 50 per

cent of the total savings of the Muslim population worldwide within an 8 to 10 year time-frame.[6]

Table 3.2.1-4 : Geographical spread of countries that offer Islamic banking products



3.2.2 Takaful

The term takaful literally means "shared responsibility or shared guarantee or assurance." In practical terms, takaful means a mutual guarantee provided by a group of people in the community against a defined risk befalling one's life, property or any form of valuable things. Unlike conventional insurance, takaful is free from elements of *gharar* (uncertainty) and *maisir* (gambling). The uncertainty element in a conventional insurance policy arises from the arrangement where the insurance company guarantees to pay a certain amount of compensation to the policyholder in the event of a disaster. However, the policy holder in the first instance does not know when such a disaster would occur or the amount of compensation that he will receive from the insurance company.

[6] See "An Overview of Islamic Finance and the Growth of Islamic Funds" by Tariq Al Rifai, Islamic Funds World 2003

Takaful is based on definite terms, and requires a transparent and clear contract to avoid elements of uncertainty. Currently, two *Shariah* principles, namely *mudharabah* (profit sharing arrangement) or *wakalah (*fee-based arrangement) are used for takaful contracts. Syarikat Takaful Malaysia Berhad, which is Malaysia's first takaful operator, for instance, adopts the principle of *mudharabah* whilst Takaful Ta'awuni, which is based in Saudi Arabia, applies the principle of *wakalah.* While both principles involve embedding the sharing of profit between participants and takaful operators in the contract, there is, however, a difference in the profit determination process as explained in the following paragraphs.

Takaful operators incorporate the insurance scheme into the structure of the instrument via the concept of donation or *tabarru'* (gift) in their operations. In this respect, the participants to the takaful scheme agree to relinquish a certain portion of their takaful contributions as a donation to assist other participants who might suffer a loss or damage due to a disaster or catastrophe.

Under *mudharabah* principles, the takaful operator acts as an entrepreneur and accepts contributions from investors on a periodic basis. The takaful terms and conditions will state how profit from the operations managed by the takaful operator will be shared on a mutually-agreed ratio between the participants as the providers of capital and the takaful operator as the entrepreneur. However, the operator is not permitted to charge and deduct management expenses from the takaful fund.

In contrast, under the *wakalah* principle, the takaful operator is permitted to charge fees at the point the contract is signed in return for its role as the agent for the participants. The operators are also allowed to use part of the fund to cover its management costs.

Another distinguishing feature of takaful compared with conventional insurance can be found in its investment choices. Takaful operators must ensure that the avenues of investment of takaful funds must be in accordance with *Shariah* principles. Takaful funds are usually invested in long-term *Shariah* compliant products and services.

The engagement of *Shariah* advisors or *Shariah* supervisory boards is also important in the takaful business. This is to ensure that day-to-day operations of takaful companies comply with *Shariah* principles.

Generally there are three types of takaful products:

a) **General takaful (Islamic general insurance)**

This offers protection or coverage against risk of a general nature for companies or individuals (participants). Some of the products are motor insurance, fire and allied perils, worker compensation, marine cargo, property insurance, transportation insurance and others.

b) **Family takaful (Islamic life insurance)**

This provides coverage for individuals or corporate bodies on a long-term basis and the maturity period ranges from 10 to 40 years. Some of the products include medical and health plans, education, accident, marriage, as well as *hajj* and *umra* plans.

c) **Retakaful coverage (Islamic reinsurance)**

The retakaful companies offer coverage for takaful companies against risks, loss or dilution of its capital and reserves resulting from high-claim exposure. There are very few Retakaful companies and they are mainly located in the Bahamas, Malaysia, Saudi Arabia and Sudan.

Takaful began in the late 1970s when Islamic scholars started to permit takaful practices – on the basis that the relationship between takaful companies and its participants can be viewed as a *mudharabah* contract which entails profit sharing arrangements. Since then, there has been a gradual establishment of takaful companies in Muslim and non-Muslim countries.

The first recognised takaful operator was the Islamic Insurance Company, which was established in Sudan in 1979. This was followed by the establishment of the Islamic-

Arab Insurance Co. in two countries; namely Saudi Arabia and United Arab Emirates in 1979 and 1980 respectively.

Subsequently, Darul Mal Al-Islamic was incorporated in Geneva in 1981. In 1983, four more takaful operators commenced business, i.e., Syarikat Takaful Al-Islamiyah in Bahrain, Islamic Takaful and Re-Takaful Co. in Bahamas and Islamic Takaful Company in Luxembourg. The list of takaful operators that were incorporated in the late 1970s and late 1990s are shown in table 3.2.2-1.[7]

Table 3.2.2-1: Takaful operators incorporated in the late 1970s and late 1990s

Name	Country	Date of Establishment
The Islamic Insurance Company	Sudan	1979
The Islamic – Arab Insurance Co	Saudi Arabia	1979
The Islamic – Arab Insurance Co	United Arab Emirates	1980
Darul Mal Al-Islami	Geneva	1981
Syarikat Takaful Al-Islamiyah	Bahrain	1983
Islamic Takaful and Re-Takaful Co.	Bahamas	1983
Islamic Takaful Company	Luxembourg	1983
Al-Barakah Insurance Co.	Sudan	1984
Syarikat Takaful Malaysia Bhd	Malaysia	1984
Islamic Insurance and Re-Insurance Company	Bahrain	1985
The PT Syarikat Takaful Indonesia	Indonesia	1994
The Syarikat Takaful Singapura	Singapore	1995
Takaful Nasional Sdn. Bhd. (Formerly known as MNI Takaful)	Malaysia	1993
Islamic Insurance Co.	Qatar	1995
ASEAN Takaful Group	Malaysia	1996
ASEAN Re-Takaful International (Labuan) Ltd (ARIL)	Malaysia	1997

[7] See " Principles & Practices of Takaful and Insurance Compared" by Mohd Ma'sum Billah, 2001

The global size of takaful premium contributions from 58 takaful operators is currently estimated at around USD 2 billion. It is reported that the takaful market in the Middle East is growing at 15-20 percent per year. There are also efforts underway to establish the world's first Global Takaful Company (GTC), headquartered in Brunei, by the IDB Fund with a market capitalisation of USD 250 to 300 million.[8] The geographical distribution of takaful products is illustrated in figure 3.2.2-2 below.

Figure 3.2.2-2: Geographical spread of countries that offer takaful products

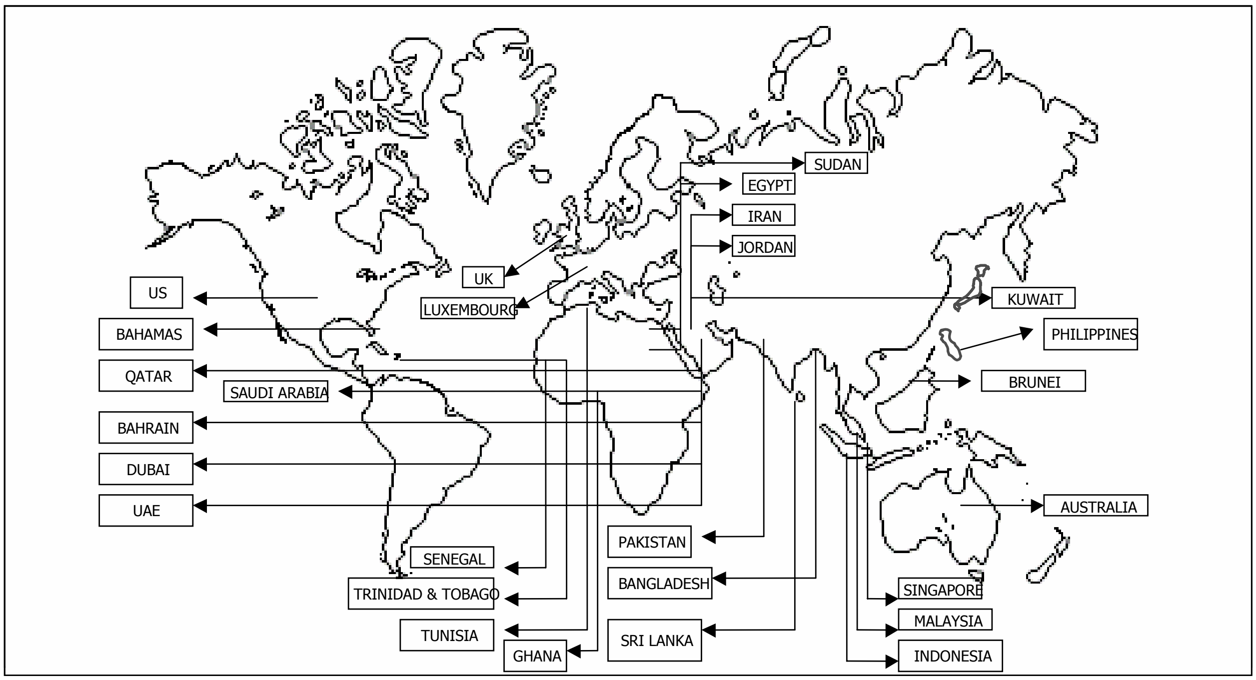


Figure 3.2.2-3: Premium contribution of takaful industry in selected Asian jurisdictions (USD Million)

Country	1999-2001	2002	Total	% Share
Malaysia (4 operators)	452.174	346.344	798.518	87.6
Brunei (3 operators)	44.894	14.787	59.681	6.5
Indonesia (3 operators + 4 branches)	26.057	12.886	38.943	4.3
Singapore (3 branches)	6.068	0.353	6.421	0.7
Bangladesh (6 operators)	2.8	4.5	7.3	0.8
Sri Lanka (1 operator)	0.223	0.321	0.544	0.1
Total	**532.216**	**379.191**	**911.497**	**100**

[8] See " Islamic Development Bank Infrastructure Fund" by Mumtaz Khan, The World Islamic Banking Conference, 2003
[9] See "Islamic Financial Services The Road Ahead" by Dato' Mohd Fadzli Yusof, OIC Business Forum 2003

3.2.3 Islamic capital markets

The emergence of a distinct Islamic capital market, where investment and financing activities and products are structured in accordance with *Shariah* principles, is therefore the outcome of a natural progression in the growth of the Islamic financial services industry. As outlined earlier, the pressing need to address liquidity management for Islamic banks and takaful operators prompted several countries – such as Malaysia, Bahrain, Kuwait, Sudan and Iran – to introduce Islamic bonds to facilitate the management of assets by Islamic financial institutions.

Whilst there had been earlier efforts by the Governments of Jordan and Pakistan[10] to introduce a legal framework for Islamic bond issuance, the first successful issuance of Islamic bonds was initiated by the Malaysian Government in 1983 with the issuance of the Government Investment Issue or GII (formerly known as the Government Investment Certificate or GIC). The main objective of this issuance was to facilitate the management of assets in the Islamic banking system, which, by this time, was fairly mature. The issuance of GII is based on the Islamic concept of *qardh hasan* (benevolent loan) non-interest bearing loans. However, GII was not a tradable instrument under the concept of *qardh hasan*, which did not permit secondary trading. Recently, the underlying concept of GII was changed to *bai` al-`Inah* to allow it to be traded in the secondary market.

Similarly, the Central Bank of Kuwait issued interest-free bonds to finance the purchase of properties held by nationals other than Gulf Co-operation Council states. Iran has also introduced the concept of participation bonds on a *mudharabah* basis. The success of numerous Islamic bond issuances worldwide opened up an alternative source of funding, which is now tapped by many countries and corporations.

Another aspect of the early part of the development of the Islamic capital market was the need to establish clear guidance on the types of equities that comply with *Shariah*

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[10] The effort was undertaken by the Jordanian Government as stipulated by Law No. 13 of 1978, which allowed the Jordan Islamic Bank to issue Islamic bonds known as *Muqaradah* bond. This was followed with the introduction of the *Muqaradah* Bond Act (1981) by the Jordanian Government to develop *waqf* property. Similar efforts in Pakistan saw the introduction of a special law called the *Modaraba* Companies and *Modarabas* (Flotation and Control) Ordinance 1980. This law was supplemented by the *Modaraba* Companies and *Modaraba* Rules (1981). However, to date, no Islamic bonds have been issued in Jordan and Pakistan.

requirements. The review and identification of *Shariah*-compliant stocks are guided by specific criteria set out by *Shariah* scholars. In Malaysia, the initial efforts to provide a list of *Shariah*-compliant stocks were undertaken by Bank Islam Malaysia Bhd in 1983. This was later followed by the introduction of a list of *Shariah*-compliant stocks in June 1997 by the Securities Commission of Malaysia.

The implementation of a process to identify *Shariah*-compliant stocks facilitates the establishment of Islamic indices. The first Islamic equity index was introduced in Malaysia by RHB Unit Trust Management Bhd in May 1996. This was followed by the launching of the Dow Jones Islamic Market Index (DJIM) by Dow Jones & Company in February 1999, the Kuala Lumpur *Shariah* Index (KLSI) by Bursa Malaysia in April 1999 and the FTSE Global Islamic Index Series by the FTSE Group in October 1999.

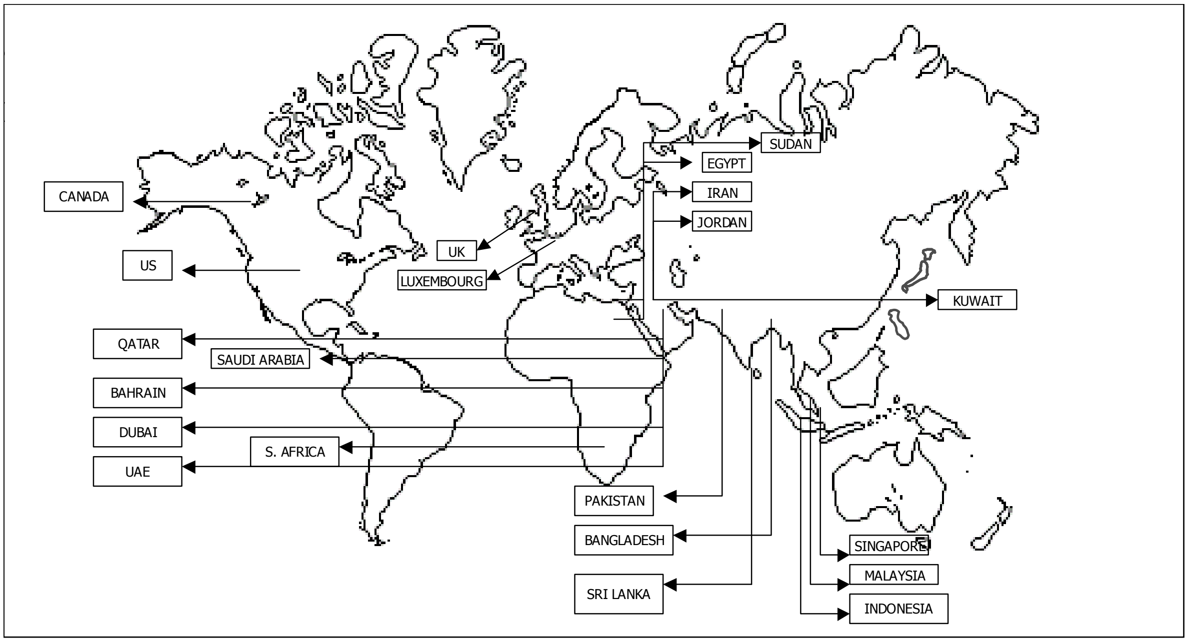
With *Shariah* investment guidance in place, the establishment of Islamic investment funds gained momentum. The Amana Income Fund, the first Islamic equity fund to be established in the United States, was formed in June 1986 by members of the North American Islamic Trust (NAIT), an organisation in Indiana, which oversees the funding of mosques in the United States.[11] In 1987, Dallah AlBaraka Group established two companies, namely Al-Tawfeek and Al-Amin, which were specifically dedicated to the development of Islamic equity funds. These companies have successfully launched a number of Islamic funds focusing on such diverse sectors such as real estate as well as international equities.

Today, there is a wide array of Islamic capital market products and services to meet the needs of those who seek to invest in compliance with *Shariah* principles. These include *Shariah*-compliant stocks, Islamic bonds, Islamic funds and Islamic risk management products. The Islamic capital market has grown in sophistication and Islamic forms of product structuring, project financing, stockbroking, asset management and venture capital services are becoming increasingly widely available.

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[11] See "Islamic Banking" by Mervyn K. Lewis and Latifa M. Algaoud, 2001

The distribution of countries that offer Islamic capital market products and services is illustrated in chart 3.2.3-1.



A. *Shariah*-compliant stocks

In general, the *Shariah*-based principle of equity participation is essentially the same as that for conventional companies. It is based on a form of equity partnership investing called *musharakah.* However, from an Islamic perspective, corporate stocks can only be classified as *Shariah*-compliant if their business activities are not related to prohibited activities as outlined by *Shariah* scholars. The prohibited business activities include:

a) Alcohol
b) Gambling
c) Pork-related products
d) Pornography
e) Conventional financial services
f) Conventional insurance.

Within this context, there may be other activities or enterprises that are prohibited such as tobacco, weapons, hotels or entertainment depending on the methodology or

interpretation used by *Shariah* scholars in different jurisdictions. In addition to the business activities criteria, certain jurisdictions use financial ratios as additional criteria in classifying *Shariah* stocks. The main financial ratios applied are:

- debt-to-equity ratio
- cash and interest bearing securities-to-equity ratio
- cash-to-asset ratio.

Other than business and financial criteria, some jurisdictions are known to also apply a cleansing mechanism to purify investments that are tainted by prohibited activities. The cleansing process is normally performed by the individual investors, although in some cases, the Islamic funds would perform the task on behalf of their investors. For instance, if some part of the income from interest-bearing accounts (prohibited by *Shariah*) is included in the income of the company, the proportion of such income in the dividend paid to the shareholder must be given to charity, and must not be retained by the shareholder. This is called purification or dividend cleansing.

In Malaysia, for example, the screening of listed stocks for *Shariah* compliance is undertaken by a centralised body. The review and identification of stocks that are considered to be *Shariah*-compliant is undertaken by the *Shariah* Advisory Council (SAC) of the Securities Commission. The Securities Commission then compiles the decisions of the SAC and publishes the list of *Shariah*-compliant stocks twice a year.

In other countries, screening services are commonly performed by the private sector rather than by the regulatory authorities. In India for instance, Parsoli Corporation and IBF Net jointly launched India's first Islamic equity index comprising *Shariah*-compliant stocks, the Parsoli IBF-Net Equity (PIE).[12] In the Middle East, private financial institutions and investment companies produce their own lists of *Shariah*-compliant stocks. As mentioned earlier, both Dow Jones and FTSE have introduced global Islamic indices, which track the performance of securities approved by their *Shariah* boards.[13] Table 3.2.3-2 shows the market capitalisation of Malaysian and

[12] Source : www.parsoli.com
[13] Dow Jones; FTSE International

Bahrain *Shariah*-compliant stocks, while table 3.2.3-3 illustrates the size of stock exchanges in selected Islamic countries.

Table 3.2.3-2: Market Capitalisation of Malaysian and Bahrain *Shariah*-compliant stocks (USD Million)

Year	Bahrain		Malaysia	
	M-cap of *Shariah*-compliant stocks	% of total market capitalisation	M-cap of *Shariah*-compliant stocks	% of total market capitalisation
1998	411.8	6.13%	55,982.8	56.00%
1999	462.7	6.46%	70,082.4	48.00%
2000	647.3	9.77%	65,129.3	54.70%
2001	612.9	9.30%	75,131.60	59.20%
2002	603.2	7.98%	76,426.32	57.55%
2003	621.2	6.40%	102,926.32	57.70%

Table 3.2.3-3: Market Capitalisation of stock exchanges in selected Islamic countries[14]

As at Dec 2003	Malaysia	Bahrain	Oman	Kuwait	Saudi Arabia	Qatar	Jordan	UAE	Egypt
Number of listed companies	906	43	130	112	70	29	178	15	157
Market capitalisation (USD billion)	165.0	28.7	4.7	57.8	151.7	25.7	10.7	13.5	21.0

B. Islamic funds

Islamic mutual funds or Islamic unit trust funds are funds, which are managed in compliance with *Shariah* principles. Islamic mutual funds typically engage *Shariah* boards to advise and ensure that investment operations and portfolios are managed in compliance with *Shariah* principles. In some jurisdictions, the retention of *Shariah* boards for Islamic funds is required under the law.

Globally, there are different categories of Islamic funds with the most common product being funds that invest in *Shariah*-compliant stocks. Examples of Islamic equity funds being launched recently include the Alfanar US Equity Hedge Fund,

[14] Sources : www.zawya.com and www.bursamalaysia.com

which was launched in 2003 as the world's first Islamic hedge fund by the Saudi Economic and Development Company (SEDCO) and the Permal Group.

Apart from Islamic equity funds, there are other categories of Islamic funds such as realty and property funds, investment and *murabahah* funds, commodity funds and leasing (*ijarah*) funds. Investment and *murabahah* funds operate with the fund manager purchasing commodities from third parties (typically through a bank as an agent of the fund) and reselling the same commodities to the bank on deferred payment terms. The bank, as an agent, ensures that transactions are based on physical commodities. The profit for each transaction is agreed to as between the bank and the fund at the time it purchases the goods and is generally set as levels comparable with the returns from money market instruments or *murabahah* fund transactions.

Realty and property funds involve the acquisition and management of a portfolio in real estate. Property funds have recently gained popularity and interest among investors in the Middle East and Europe. In addition, there are also Islamic real estate investment trusts (REIT) funds which invest their portfolios in listed real estate securities that own and operate real estate such as residential, commercial, and retail properties, storage facilities, warehouses and car parks. Islamic property funds and Islamic REITs differ from conventional property funds and REITs only in terms of the requirement to observe Islamic investment guidelines and *Shariah* principles. The *Shariah* principles, in this case, would extend to the activities and businesses undertaken by the tenants of the properties of the fund.

Islamic commodity funds invest in commodities, which are permissible according to *Shariah*. Among the popular commodities are metals such as aluminium, copper, nickel, palladium and platinum. Other types of Islamic funds include the leasing (*ijarah*) fund, which invests in leasing transactions that satisfy *Shariah* requirements.

In general, the categories of Islamic funds are reflected in figure 3.2.3-4.

Figure 3.2.3-4: Categories of Islamic funds[15]

Type of funds	Funds name
Global funds	Al-Rajhi Global Equity, NCB Global Trading Equity, Wellington Hegira, Al Sawfa, Al Baraka, Al Fanar Investment Holdings, Al-Dar World Equities, Riyad Equity Fund, Oasis International Equity
Regional funds	Mendaki Growth, Al Rajhi Middle East, TII Ibn. Majid, Al-Nukhba
Sector funds	TII Small-Capital, Amana Income, Hi Tech Fund
European funds	Al-Dar European Equities, European Trading Equity Fund
Domestic funds	Most Malaysian funds, Saudi Trading Equity, Al Rajhi Egypt, US equity funds
Hedge funds	Alfanar US Equity Hedge Fund
Index funds	Dow Jones Islamic Market Index Fund
Leasing (*ijarah*) funds	GCC Leasing, Al Kawthar Ijara Fund
Realty & property funds	Al-Deara Real Estate Fund, Badr Property Fund, First Industrial Fund
Commodity funds	Commodity fund (Euro), commodity Mudaraba, Al-Rajhi Commodity Mudaraba
Investment & *Murabaha* funds	Alfanar Murabaha Ltd, Noriba Murabaha Fund, Murabaha Fund
Trade finance funds	Al-Bard fund, AIF Trade, Al-Ahli International Trade, SAR Trade Finance

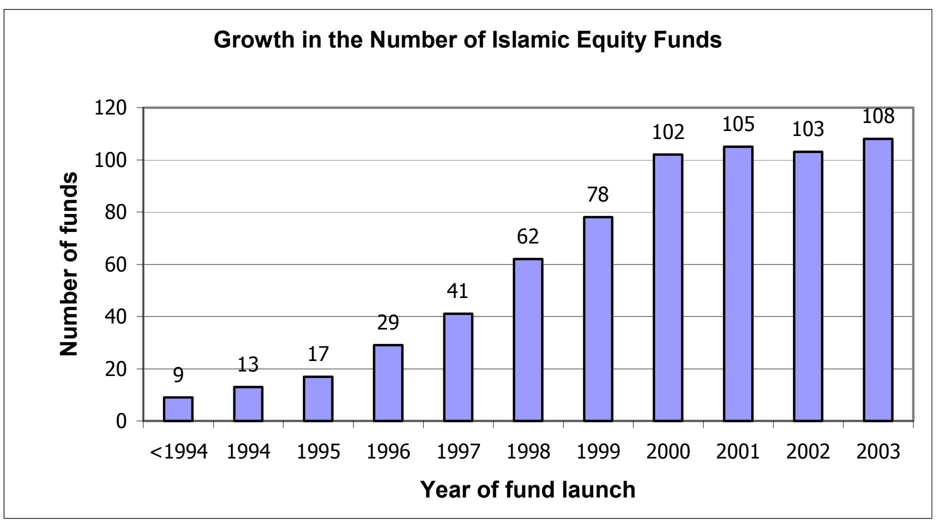
Between 1994 and the end of 2001, approximately 120 Islamic funds have been launched by both Islamic and conventional institutions. Of these, over 60 percent of these funds were established to invest in international equities. Although most Islamic

[15] See "Islamic Banking" by Mervyn K. Lewis and Latifa M. Algaoud, 2001

funds have targeted institutional and professional investors, some of the international Islamic equity funds have been distributed at the retail level as well. Amongst them are Al Rajhi Banking and Investment Corporation that have moved on from trade and commodity *mudharabah* to offer its clients several *Shariah*-compliant global and regional equity funds. In Malaysia, Islamic funds have been in existence since the launch of the first Islamic equity fund by Arab-Malaysian Unit Trust Berhad in 1993. Since then, 55 Islamic funds have been launched, representing approximately a quarter of the total of 226 funds in the country.[16]

Currently, the size of Islamic equity funds is estimated to be approximately USD 3.3 billion and it has been growing at over 25 per cent over the past seven years. There are estimated to be over 100 Islamic equity funds worldwide.[17] The rapid growth of the number of Islamic equity funds and its assets is expected to continue as new players enter the market due to enhanced awareness and familiarity with the products.

Figure 3.2.3-5: Statistics on the growth in the number of Islamic equity funds

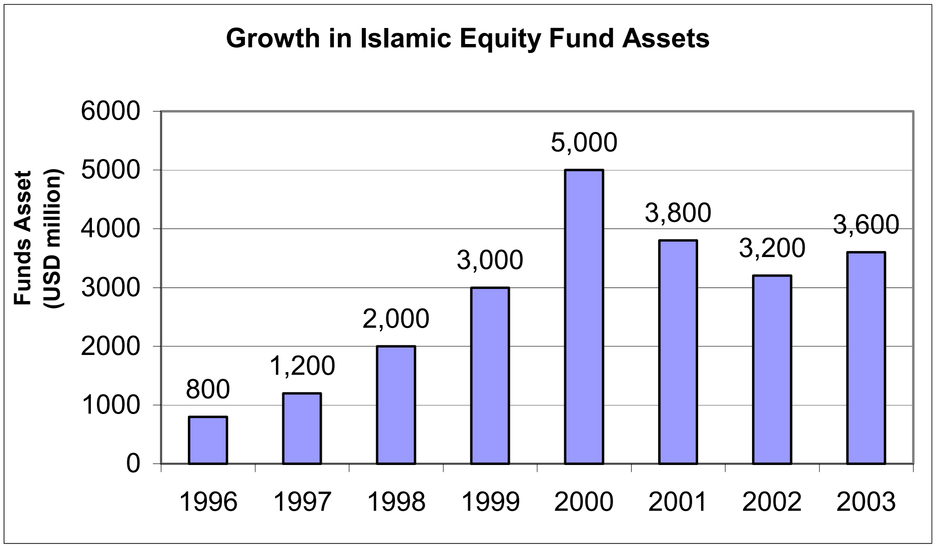


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[16] As of December 2003

[17] See "An Overview of Islamic Finance and the Growth of Islamic Funds" by Tariq Al Rifai, Islamic Funds World 2003

Figure 3.2.3-6: Statistics on the growth in Islamic equity funds assets



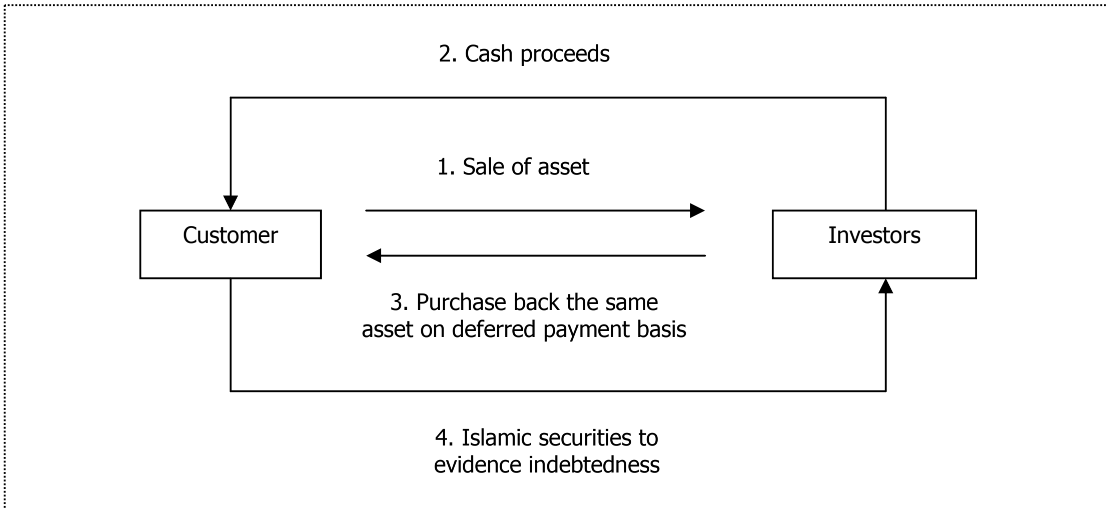
C. Islamic bonds

The origination of Islamic bonds typically involves the packaging or structuring of pools of *Shariah*-compliant assets with or without credit enhancement into securities. It is structured based on a specific contract of exchange that can be made through the sale and purchase of an asset based on deferred payment, leasing of specific assets or participation in joint-venture businesses. Unlike conventional bonds, the issuance of Islamic bonds requires an exchange of a *Shariah*-compliant underlying asset for a financial consideration through the application of various *Shariah* principles such as *ijarah, mudharabah, musharakah, bai` bithaman ajil* and others. The structure of Islamic bonds has to be reviewed and approved by *Shariah* advisers to ensure that the structures are in compliance. In addition, the structuring process may also involve the provision of additional protection for investors against late payment, pre-payments, potential write-offs and others. Such protection is often provided in the form of credit and/or liquidity enhancement schemes.[18]

A simplified structure of Islamic bonds using *bai` bithaman ajil* is shown below in figure 3.2.3-7.

[18] See "Islamic Securitisation : Practical Aspects" by Suleiman Abdi Dualeh

Figure 3.2.3-7 Islamic bonds based on *bai` bithaman ajil* structure



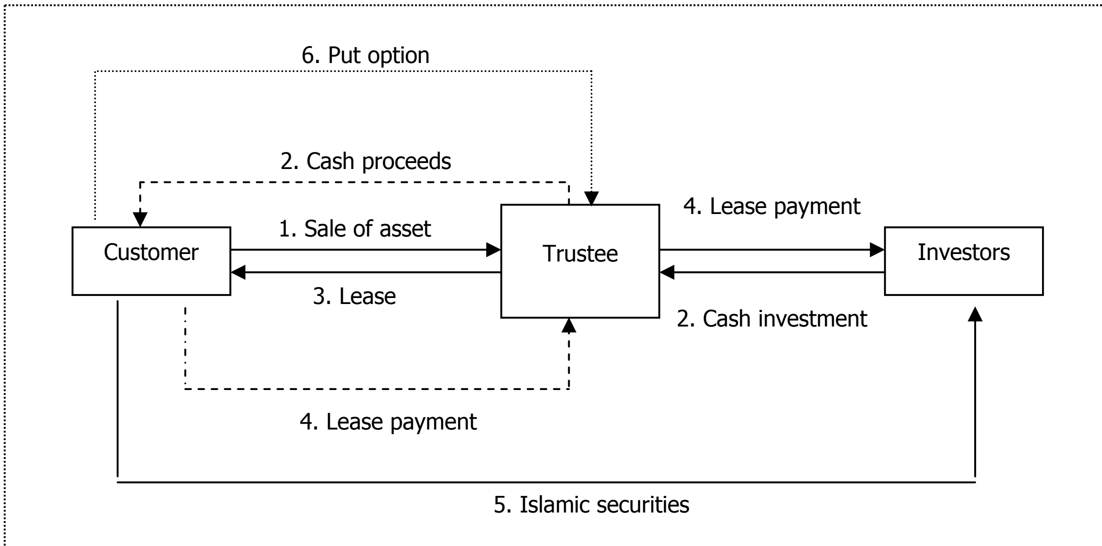
- The customer and investors identify certain customer's asset. The customer enters into an agreement to sell an asset, for example, a building to the investors. The title to the asset passes to the investors immediately upon the sale of the asset. In return the customer will receive cash proceeds from the transaction.

- The customer will then buy back immediately from the investors the same asset at an agreed price on a deferred payment basis (purchase price plus margin of profit). The title to the assets reverts back to the customer who, as a result of transactions will be indebted to the investors. The repayment of this debt, comprising the purchase price and profit will then be deferred and subsequently executed over an agreed period.

- Subsequently, the customer issues Islamic securities (which can be traded) to the investors to reflect the above financing arrangement and as evidence of the customer's obligation to pay the purchase price and profit to the investors.

In trade finance, Islamic institutions use the *murabahah* contract, which enables the Islamic institutions to purchase certain goods and re-sell the same to the client. In project financing, Islamic institutions use the *ijarah* form of contract to buy equipment and lease it to a project-promoter. A simplified structure of an asset-backed securitisation based on *ijarah* is shown in figure 3.2.3-8

Figure 3.2.3-8 Asset-backed structure based on *ijarah* structure



- The customer enters into an agreement to sell an asset, for example, a machine to a third party. In this case, the third party can be a trustee [or special purpose vehicle (SPV)]. The trustee acts on behalf of investors who provide the funds for the purchase of the machine. The title to the machine passes to the trustee as an agent and trustee for the investors immediately upon the sale of machine. The trustee, on behalf of the investors, then leases the machine to the customer under the *Shariah* principles of *ijarah* where the customer will make lease payments to the trustee throughout the leasing period.

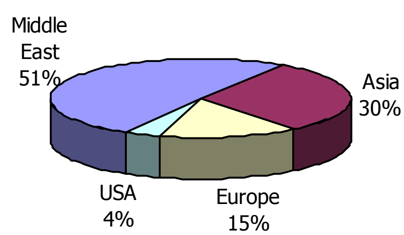
- Subsequently, the customer issues Islamic securities to the investors to reflect the above financing arrangement. The returns to the investors are in the form of leasing profits and the principal amount (face value of the securities) will be paid to the investors at maturity of the securities. The customer grants a put option to the trustee where at the end of the *ijarah* facility period, the trustee can exercise the put option which requires the customer to purchase the machine back from the trustee.

The *ijarah* concept is one of the more popular concepts among issuers of global Islamic bonds. This is reflected by the strong reception and success of global Islamic bonds issued by sovereigns (Malaysia and Qatar); corporations (Guthrie Berhad – a

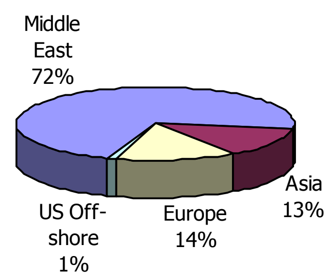
Malaysian public listed company); and multilateral organisations like the Islamic Development Bank (IDB). All these bonds were reviewed and endorsed by the Global *Shariah* Supervisory Committee (SSC) of the International Islamic Financial Market (IIFM) Board.

A geographical breakdown of the international investors who subscribed to the Malaysian, Qatar and IDB Global Islamic Bonds is provided below:[19]

Analysis of distribution of Malaysian Global Bond by geographical location:

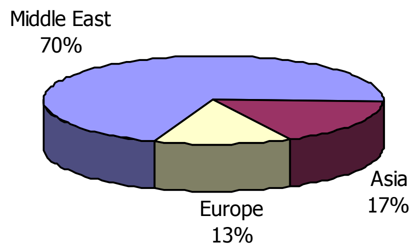


Analysis of distribution of Qatar Global Bond by geographical location:



[19] Source: HSBC

Analysis of distribution of Islamic Development Bank Bond by geographical location:



Currently, the value of Islamic bonds issued globally is estimated at USD 25.8 billion. (see figure 3.2.3-9).

Figure 3.2.3-9: Size of Islamic bonds issued by selected jurisdictions as of 31 December 2003

No.	Issuing Country	Size (USD million)
1.	Qatar (Global)	700
2.	Islamic Development Bank (Global)	400
3.	Bahrain	1,000
4.	Malaysia	22,680
5.	Malaysia (Global)	600
6.	Guthrie Bhd (Global)	150
7.	Indonesia	119
8.	Singapore	35
9.	Sudan	148
	Total	25,832

D. Islamic stockbroking services

Islamic stockbroking services operate within the same institutional and regulatory framework as that of conventional stockbroking, except that their activities comply with *Shariah* principles. For example, they are allowed to participate in originating, trading and distributing *Shariah*-compliant stocks only. Islamic stockbroking services also provide margin financing facilities but these are structured based on *Shariah* principles. As is the case for the banking sector, there are conventional stockbroking companies that provide "Islamic windows" which offer Islamic stockbroking services to their clients. However, the accounts of Islamic stockbroking services are segregated from the company's conventional stockbroking operations.

In Malaysia the first full-fledged Islamic stockbroking service was launched by BIMB Securities Sdn Bhd (a subsidiary of Bank Islam Malaysia Bhd) in 1994. There are also a number of conventional stockbroking companies in Malaysia that offer Islamic stockbroking services alongside their conventional stockbroking services. Kuwait also follows a similar approach to Malaysia where the Government of Kuwait recently approved requests by local stockbroking companies to operate under *Shariah* principles. In addition, the first UK stockbroking service complying with *Shariah* principles was established in 2003.

3.3 International Islamic institutions

3.3.1 Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)

Islamic financial products and services differ from conventional financial products and services in terms of philosophy and structure. This creates a challenge for Islamic financial institutions to produce a "true and fair" view of Islamic financial transactions. This task is further compounded by the rapid expansion in the breadth and depth of Islamic capital market activity as measured in terms of the number of institutions as well as by the variety, complexity and sophistication of products and services.

In some cases, Islamic financial institutions encounter accounting problems because the existing accounting standards such as International Accounting Standards (IASs), Generally Accepted Accounting Principles (GAAPs) or domestic standards, were developed based on conventional institutions, conventional product structures or practices, and may be perceived to be insufficient to account for and report Islamic financial transactions. *Shariah* compliant transactions may not have parallels in conventional financing and therefore, there may be significant accounting implications. For example, in the case of *Mudharabah* contracts, the transaction is neither equity nor liability in nature as the depositor does not assume the rights of an equity holder (i.e., shareholder) of the Islamic financial institution and neither is he guaranteed of returns. Hence, from an Islamic accounting viewpoint, a *Mudharabah* account may be presented as an 'investment account', appearing as a separate line item from equity or liability on the balance sheet.

The need to develop accounting standards that adequately and appropriately reflect the nature of Islamic financial transactions was viewed by some as an important step to enhance the reliability, consistency and clarity of financial reporting by Islamic financial institutions which would also enhance investor confidence in Islamic finance.

Arising from this, intensive efforts were made by the Islamic Development Bank (IDB) to establish a formal entity to address Islamic accounting issues. This led to the establishment of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) which was registered in March 1991 in Bahrain as an international autonomous non-profit making corporate body. The objective of the organisation is to prepare and develop accounting, auditing, governance and ethical standards relating to the activities of Islamic financial institutions, taking into consideration international standards and practices and the need to comply with *Shariah* rules.

As at end 2002, AAOIFI has issued 18 financial accounting standards, four auditing standards, four governance standards and two codes of ethics. It has also issued a Statement on the Purpose and Calculation of the Capital Adequacy Ratio for Islamic Banks.

AAOIFI also takes part in efforts to achieve harmonisation in concepts and application among the different *Shariah* supervisory boards of Islamic financial institutions in different jurisdictions through the preparation, issuance and interpretations of *Shariah* standards for Islamic financial institutions. In this respect, AAOIFI has successfully issued 13 *Shariah* standards as at end 2002 including standards for *istisna'* and parallel *istisna'*, *musharakah, mudharabah, salam, ijarah and murabahah.*

AAOIFI also works towards persuading regulatory authorities to adopt its standards. AAOIFI's standards are currently mandatory in Bahrain, Sudan, Jordan and Qatar. They are also being implemented as guidelines by the Monetary Agency of Saudi Arabia and are being used as the basis on which the Malaysian Accounting Standards Board (MASB) develops its domestic Islamic accounting standards.

3.3.2 Liquidity Management Centre (LMC)

As Islamic financial transactions increasingly become global in nature, there are concerns over the sufficiency of supply of appropriate instruments to address the global liquidity management needs of Islamic financial institutions. These concerns led to the establishment of the Liquidity Management Centre (LMC) in February 2002. The LMC is based in Bahrain and is part of a larger project to create an International Islamic Financial Market (IIFM).

LMC was established to facilitate the creation of an Islamic interbank money market that would enable Islamic financial institutions to manage their liquidity effectively. In addition, the establishment of LMC facilitates the pooling of assets acquired from governments, financial institutions and corporations. This asset pool will be securitised through the issuance of tradable instruments or *sukuks* for Islamic financial services institutions to invest their surplus liquidity. By creating a secondary market for the trading of these instruments, the LMC is able to provide competitive returns on short-term, liquidity investment opportunities for Islamic financial services institutions

3.3.3 International Islamic Financial Market (IIFM)

The International Islamic Financial Market (IIFM) was established in November 2001 and began its operations on April 1, 2002 with a view towards facilitating the establishment of a cooperative framework among the existing 265 Islamic banks and other financial institutions worldwide to encourage product development and the trading of *Shariah*-compliant products in the secondary market.

With the objective of enhancing cross-border acceptance of Islamic financial products, the IIFM is also intended to provide independent *Shariah* advice and guidelines for the issuance of new Islamic financial products. The Global *Shariah* Supervisory Committee (SSC), which was established by the IIFM Board of Directors, will take on the role of reviewing and endorsing new products. IIFM's endorsement will facilitate cross border listing on various international stock exchanges, thereby encouraging the trading of Islamic products and instruments in the secondary market. Thus far, the IIFM has endorsed four global Islamic bonds, issued by the Malaysian government, the Bahraini government, the Islamic Development Bank and more recently the Qatar government.

3.3.4 Islamic Financial Services Board (IFSB)

With the rapid development in the Islamic financial services industry, it was perceived that there was a lack of integrated supervision and regulation of the unique risks associated with Islamic financial products and that there was a need to develop standards to address these risks. For this purpose, the Islamic Financial Services Board (IFSB), which is based in Kuala Lumpur, was established in November 2002. The IFSB serves as an association of central banks, monetary authorities and other institutions that are responsible for the regulation and supervision of the Islamic financial services industry. The IFSB is expected to play a significant role in developing international prudential and supervisory standards and best practices for Islamic financial institutions.

The IFSB intends to liaise and co-operate with other standards-setting bodies in the areas of monetary and financial stability, and will promote good practices in risk management in the industry through research, training and technical assistance.

The IFSB has started to develop two prudential standards for the Islamic financial services industry, namely capital adequacy and risk management standards. These standards, which are expected to be issued by early 2005, will address the identification, classification, measurement and reporting of the risks for Islamic financial institutions. For the future, the IFSB is planning to develop standards on corporate governance, transparency and market discipline.

3.3.5 International Islamic Rating Agency (IIRA)

The Islamic Development Bank (IDB) established the International Islamic Rating Agency in Bahrain in October 2002. The IIRA was established to rate, evaluate and provide independent assessments and opinions on the likelihood of any future loss by Islamic financial institutions as well as their products and services. IIRA will also assess the *Shariah* compliance aspects of Islamic financial institutions and Islamic financial products. The data and information relating to rated entities and financial instruments will then be published and disseminated to the public. In addition, IIRA will also introduce a set of rating products and services, including *Shariah* transparency, for both financial products and their issuers.

Chapter 4 : Developmental and regulatory issues

4.1 Introduction

This Chapter identifies specific industry issues and will cover both regulatory issues as well as public and private sector initiatives within IOSCO members jurisdictions to accelerate the growth of the Islamic financial services industry.

The issues discussed have been largely distilled from the data and findings from the Task Force's survey and interviews with selected industry participants, as well as from the extensive research conducted by the Task Force. This work represents the first jurisdictional comparison of practices and approaches on Islamic capital market regulation. It is hoped that the extensive information collated for the purpose of this report as well as the discussions below will act as a catalyst for further research and analysis of regulatory issues relevant to the development of the Islamic capital markets.

With reference to the mandate given to this Task Force, the discussion places particular emphasis on IOSCO's role as an international regulatory standards setter. Whilst the report does not seek to make recommendations, regulatory issues are discussed within the framework of the objectives of IOSCO: that is, the protection of investors, the reduction of systemic risk and ensuring that markets are fair, efficient and transparent. In particular, the report discusses the application of the IOSCO Principles in relation to Islamic capital market activities.[20]

As mentioned above, many of the issues also consider developmental factors taking into account the fact that the Islamic capital market is a relatively new market segment. In this regard, reference is also made to the preamble of IOSCO's By-Laws, which states:

[20] In this respect, it should be recognised that other international Islamic organisations, such as the Islamic Financial Services Board (IFSB) with its role in the harmonisation of prudential standards for Islamic financial institutions, are also working towards similar objectives, and that there is a need to co-ordinate or rationalise these efforts by the various international organisations.

Securities authorities resolve to cooperate together to ensure better regulation of the markets, on the domestic as well as international level, in order to maintain just, efficient and sound markets:

- To exchange information on their respective experiences in order to promote the development of domestic markets;
- To unite their efforts to establish standards and an effective surveillance of securities transactions;
- To provide mutual assistance to ensure the integrity of the markets by a vigorous application of the standards and by effective enforcement against offences.

The Task Force believes there is a need for greater understanding of the developmental issues in relation to strengthening regulatory functions within Islamic capital markets, both on a domestic and a cross-border basis. This report seeks to look deeper into these issues. While religious aspects, particularly in the area of Shariah interpretations and convergence, are important in this market segment, it is, however, not within the objectives and expertise of IOSCO to provide guidance or to facilitate discussion on these issues. As such, while this report recognises the issues, it will not seek to discuss the matter any further than stating the facts as collated in the findings of the study.

4.2 Methodology

In order to facilitate the collation of current data, the Task Force formulated a comprehensive questionnaire that was circulated to selected IOSCO members as well as to selected external parties.

The survey questionnaire was structured to cover the following broad areas:

a) Regulatory framework issues with respect to Islamic capital market products and services, and issues pertaining to *Shariah* compliance and investor protection;
b) Market foundation issues such as accounting and tax frameworks; and
c) International issues pertaining to cooperation and collaboration efforts among various jurisdictions, and harmonisation efforts among *Shariah* scholars.

The feedback from the questionnaire formed a useful basis for cross-jurisdictional comparison of market developmental and regulatory issues experienced by different jurisdictions. In addition, intensive research of secondary sources was conducted, and discussions were held with selected industry participants to obtain further views and insights. This information was used to complement responses received from the survey.

4.3 Survey Findings

The survey process revealed the challenge of compiling a comprehensive set of information and data for a comparatively new capital market segment. Despite the constraints arising from the lack of established databases, the Task Force nonetheless received responses from 30 respondents, out of 76 survey targets. This represents a 39% feedback rate.[21]

The research and survey findings are discussed under two main categories; namely the profile of the Islamic financial services industry and key issues relating to the Islamic capital market.

4.3.1 Profile of the Islamic financial services industry

Feedback from the survey indicated that Islamic financial activities generally comprise deposit taking, financing of mortgages and businesses, takaful, stocks, bonds and funds. 24 out of the 30 survey respondents indicated that there were

[21] The survey questionnaires were sent to all members of the taskforce (11 jurisdictions), 39 other identified IOSCO countries and 26 external participants.

Islamic financial activities in their jurisdictions. The list of the survey respondents that have Islamic financial activities in their jurisdictions are shown in table 4.3.1-1.

Table 4.3.1-1: Survey respondents that have Islamic financial activities in their jurisdictions

1	Australia	**13**	Nigeria
2	Bahrain	**14**	Pakistan
3	Bangladesh	**15**	Qatar
4	Bosnia	**16**	Singapore
5	Ontario, Canada	**17**	South Africa
6	Dubai	**18**	Sri Lanka
7	India	**19**	Sudan
8	Indonesia	**20**	Thailand
9	Jordan	**21**	Turkey
10	Korea	**22**	United Arab Emirates
11	Labuan	**23**	United Kingdom
12	Malaysia	**24**	United States

Out of these 24 survey respondents, one jurisdiction, Sudan, stated that its financial market was based entirely on *Shariah* principles. Based on secondary sources, the Task Force understands that Iran has also adopted the same approach in developing its financial market. The other 23 jurisdictions stated that the Islamic financial market operates alongside their conventional financial system. This indicates that most countries have opted for a system of co-existence rather than exclusivity. Generally, in a country where both financial systems co-exist, conventional financial institutions are allowed to offer financial services that comply with *Shariah* principles and to trade Islamic financial products through a dedicated Islamic unit, better known in some countries as “Islamic windows.” Malaysia, for instance, allows conventional financial institutions to operate Islamic windows to encourage and facilitate greater access to a wider customer base and to provide more variety and choice of financial services and products to customers.

In terms of the composition of the components of the Islamic financial services industry, 14 survey respondents indicated that Islamic financial activities are undertaken in the banking, takaful and capital market sectors. Four respondents indicated that their jurisdictions had Islamic banking and takaful activities, while one jurisdiction stated that it had Islamic banking and Islamic capital market activities. In addition, three jurisdictions reported Islamic financial activity in the banking sector only, while another two jurisdictions reported only Islamic capital market activities. The result of the findings on the type of Islamic financial activities found in the jurisdictions of the 24 survey respondents are shown in table 4.3.1-2:

Table 4.3.1-2 Islamic financial activities

Islamic financial activities	Jurisdictions
Islamic banking, takaful and Islamic capital market	Bahrain, Bangladesh, Dubai, Indonesia, Jordan, Labuan, Malaysia, Pakistan, Qatar, Singapore, Sri Lanka, Sudan, United Kingdom and United States
Islamic banking and takaful	Australia, United Arab Emirates and Nigeria
Islamic banking and Islamic capital market	South Africa
Islamic capital market and takaful	-
Islamic banking only	Bosnia, Korea, Thailand and Turkey
Takaful only	-
Islamic capital market only	Ontario (Canada) and India

4.3.2 Key issues relating to the Islamic capital market

The key issues identified and discussed below relate to: (a) the regulatory framework governing Islamic capital markets; (b) *Shariah* compliance and convergence; (c) the range of products in this market segment; (d) cost factors involved in transactions (including tax-related issues affecting Islamic capital market transactions; (e) development of market professionals; (f) investor education; and (g) knowledge

sharing. Issues concerning the IOSCO principles are discussed under the topic of regulatory framework.

A. Regulatory framework

An effective legal, regulatory and supervisory framework provides the essential foundation for the functioning of a modern capital market. For a rapidly growing market like the Islamic capital market, it is important to ensure that an enabling and conducive regulatory environment exists to adequately regulate the Islamic capital market. Individual members may also wish to address any factors that may impede effective product development and innovation or discourage participation in Islamic capital market transactions.

Based on the information collated, most jurisdictions surveyed as well as market professionals, are of the view that Islamic capital market activities can be adequately regulated within the framework of the conventional market. In fact, most survey respondents stated that their conventional domestic securities regulatory framework is equally applicable to the Islamic capital market (as shown in table 4.3.2-1), which suggests the applicability of the IOSCO principles to the Islamic capital market. Five countries, however, indicated that, from their perspective, the conventional regulatory framework alone is not adequate for Islamic capital market products and activities. Follow-up discussions revealed that these respondents did not necessarily feel a need for a new regulatory framework, but rather that their domestic regulatory framework required enhancements as well as some regulation tailored towards meeting the specific needs of Islamic capital market products, services and activities.

Table 4.3.2-1 Regulatory frameworks to govern Islamic capital market products and activities

No	Conventional regulatory framework is adequate to regulate Islamic capital market products and activities	Conventional regulatory framework is not adequate for Islamic capital market products and activities
1.	Australia	Indonesia
2.	Bahrain	Jordan
3.	Bangladesh	Pakistan
4.	Bosnia	Turkey
5.	Ontario, Canada	United Arab Emirates
6.	Dubai	
7.	India	
8.	Korea	
9.	Labuan	
10.	Malaysia	
11.	Nigeria	
12.	Qatar	
13.	South Africa	
14.	Singapore	
15.	Sri Lanka	
16.	Sudan	
17.	Thailand	
18.	United Kingdom	
19.	United States	
	19	**5**

IOSCO members and many market practitioners have affirmed the applicability of the three objectives of securities regulations and the thirty principles underlying them, as contained in IOSCO's *Objectives and Principles of Securities Regulation*. The survey and literature on Islamic capital markets reveal that in terms of regulatory development in domestic markets, particular attention has been given to ensuring that the Islamic capital market operates at a level playing field as the conventional market. Whilst in many cases this involves non-regulatory issues and aspects such as the applicable tax regime, equally important is the need for clarity and consistency in the regulatory principles and objectives as applied to Islamic capital market activities.

Furthermore, individual IOSCO members may wish to consider further specialised regulation and/or best practices in some areas of Islamic capital markets. This refers to in particular, qualitative aspects of regulatory processes in relation to the *Shariah* compliance of Islamic capital market products and services. Individual IOSCO members may wish to pursue together the development of robust controls and standardisation through the adoption of best practices to ensure that there are no lapses in controls on product disclosure and suitability for end-clients in relation to Islamic capital market products and services.

A-1 Application of IOSCO's Objectives and Principles of Securities Regulation

Given that the Islamic capital market is primarily viewed as a segment of the conventional market (the main differences being in the structure of products, services and other activities) the IOSCO Principles can and should apply equally to the Islamic capital market. The section that follows provides a discussion of issues with regards to some of the IOSCO Principles within the context of the Islamic capital market.

A-1.1 *Principles relating to the Regulator*

The pertinent IOSCO principles relating to the regulator in the context of the Islamic capital market are:

- Principle 3: The regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers; and
- Principle 4: The regulator should adopt clear and consistent regulatory processes.

In relation to Islamic capital market products and activities, regulators should begin to consider issues related to the clarity and consistency of regulation and their application. Furthermore, regulators should consider and/or review its capital market laws to ensure that it adequately deals with the risks associated with the new product structures based on the *Shariah* principles of *Mudharabah* (profit sharing), *Musyarakah* (profit and loss sharing) and *Murabahah* (trade with mark-up or cost plus

sale).[22] In this regard, some regulators have sought to mitigate these risks through enhanced disclosure requirements for specific Islamic products.

Due to the unique aspects of Islamic capital market products and services, there is a view, which advocates that specialised regulation for the Islamic capital market may be more appropriate. Whilst most jurisdictions apply exactly the same set of regulations in terms of product approvals as well as standards for intermediaries and other regulated entities (such as collective investment schemes), other jurisdictions have developed additional regulations, rules and guidelines catering to Islamic capital market activities. For example, Bahrain has recently issued Guidelines for Issuing, Offering and Listing of Debt Securities, which lay down clear requirements and conditions for issuers as well as for each class of debt securities, such as Islamic bonds.[23] Malaysia also has in place additional requirements for Islamic bonds within its Guidelines on the Offering of Private Debt Securities while Pakistan has specific legislation (Modaraba Companies and Modaraba (Flotation and Control) Ordinance 1980) to regulate Modaraba companies, which are the main issuers of Islamic equities. In many cases, these regulatory requirements relate to additional disclosures as a result of the structure of the product. In some cases, additional regulatory requirements are imposed on Islamic financial intermediaries such as requiring professionals to have adequate knowledge in *Shariah* law as well as requirements related to the internal controls of the intermediary.

Whatever the approach taken by the regulator, it is critical that regulators are well apprised of developments within this market segment, particularly where there is a significant level of activity occurring in the market. In the course of its work, the Task Force was informed by a statutory regulator that there were no Islamic capital market activities within its market, whereas subsequent follow-up with private sector participants and a review of secondary information confirmed the existence of such activities in the market. As the pace of market evolution and development sometimes outstrips regulatory oversight, regulators face the constant challenge of optimising its resources and capacity in a manner that enables adequate monitoring of the market and timely regulatory response.

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[22] See discussion on risk profiles of Islamic intermediaries in "Regulating Islamic Financial Institutions: The Nature of the Regulated", El-Hawary, Grais and Iqbal, World Bank Policy Research Working Paper 3227, March 2004.
[23] Issued in March 2004

Towards this end, several regulatory authorities have dedicated staff that looks into product origination and innovation and expansion opportunities available within this market segment with a view to creating regulatory incentives to promote the growth of this market segment. Labuan (Malaysia's offshore financial centre), for instance, has established an Islamic Financial Development Division, while the Malaysian Securities Commission has an Islamic Capital Market Department. In addition to developmental work, these dedicated units, together with the other relevant supervisory departments, work together with respect to regulatory functions such as licensing, supervision, inspection, investigation and enforcement, with specific reference to Islamic capital market activities. Malaysia for instance, whose Islamic capital market is considered relatively developed, recognises that certain areas of regulation, particularly inspection and supervision, need to be further enhanced to ensure that its Islamic capital market is appropriately regulated. As discussed later, accounting practices for Islamic capital market activities can be significantly different. Disclosure, provision of investment advice and know-your-customer rules should also take into account the specific nature and objective of the investment.

Individual IOSCO members may conclude that their regulators need to be equipped with the capacity and skills to regulate and supervise Islamic capital market products and services. Individual IOSCO members also may wish to pursue policies which ensure regulatory parity with similar products and services offered in the conventional capital market. Areas such as the availability of information, training and capacity building of regulatory authorities in this area may be considered as essential. In instances where market regulation is conducted by self-regulatory organisations, the same issues are applicable.

A-1.2 *Principles for Co-operation in Regulation*

These principles relate to the need for regulators to establish information sharing mechanisms to enable the effective discharge of their functions and exercise of their powers. While cross-border regulatory co-operation for the purpose of surveillance and enforcement of securities laws is critical, Islamic capital market jurisdictions may wish to explore common areas for development and to pool their resources to

facilitate standardisation of regulation and product structure, and to accelerate the pace of innovation. From discussions with various experts it appears that what is clearly lacking is an understanding of how different jurisdictions regulate Islamic capital market activities. Whilst conventional regulation applies, some jurisdictions from time to time also make additional regulatory decisions pertaining to Islamic capital market activities.

The views of the individual jurisdictions revealed that, at the present, there are minimal co-operative and collaborative efforts between different jurisdictions at the international level in relation to the Islamic capital market. However, the majority of survey respondents indicated an interest towards an international cooperative framework for regulatory purposes. The survey findings also indicate that individual jurisdictions have adopted varying approaches towards the supervision and regulation of their Islamic capital markets. The lack of a uniform approach arises due to the lack of international co-ordination on the regulatory approach towards the Islamic capital market and this appears to be an important gap in regulatory coverage.

Enhanced global co-operation and linkages would complement efforts undertaken by individual jurisdictions in isolation and add value to each other's efforts. For example, the establishment of the International Islamic Financial Market strengthened links between Malaysia, Bahrain, Brunei, Indonesia, Sudan and the Islamic Development Bank, and provided a forum whereby they could engage and cooperate to enhance the issuance of Islamic capital market products. The establishment of the Liquidity Management Centre was a global effort to address the issue of poor liquidity in Islamic financial instruments. In many cases, central banks have led these initiatives.

The survey findings also raise the issue as to the appropriate role for IOSCO – which has as its main objective the formulation of standards for effective regulation and surveillance of the international securities markets – in addressing the compliance of the Islamic capital market with IOSCO's Objectives and Principles. International co-operation could facilitate an assessment of the level of compliance with respect to Islamic capital market activities.

Individual IOSCO members also may wish to enhance the interaction among Islamic financial institutions in the global Islamic capital market system. Increased interaction between the institutions from different jurisdictions would lead to greater information sharing and the exchange of ideas between *Shariah* scholars and jurists as well as market participants. This would be an important step towards facilitating greater discussion and collaboration among individual jurisdictions to overcome regulatory and developmental challenges in the global Islamic capital market.

A-1.3 *Principles for Issuers*

Principles 14 to 16 of IOSCO's *Objectives and Principles of Securities Regulation* deal with the following:

- Principle 14: Requires full, accurate and timely disclosure of financial results and other information which is material to the investors' decision;
- Principle 15: Holders of securities in a company should be treated in a fair and equitable manner;
- Principle 16: Accounting and auditing standards should be of high and internationally acceptable quality.

Principles 14, 15 and 16 should apply equally to Islamic capital market issuers, offerings, listings, periodic reports, reports of material events, takeovers or the change in control or change of interest associated with the holding of a publicly traded security.

In the case of an Islamic product offering, over and above the regulations mentioned in the earlier-cited principles, issuers generally also provide additional statements in the offer document relating to *Shariah* aspects. For instance, statements in the prospectus of an Islamic fund should cover matters such as the role and responsibilities of the fund's *Shariah* adviser. Typically, this is achieved through explanations such as: "The role of the *Shariah* adviser to the Fund is to ensure that the operations and investments of the Fund are *Shariah*-compliant. The *Shariah* adviser meets with the Manager on a bi-monthly basis to review and advise on the Fund's

conformance with *Shariah* principles. Final responsibility for ensuring proper compliance of the Fund with *Shariah* principles in all relevant aspects rests solely with the Manager."[24]

In many cases, the issuer would have undergone an accreditation process whereby the business activities and the method of financing it adopts would have been scrutinised to ascertain if it meets with *Shariah* principles. However, it should be noted that the screening process for *Shariah* compliance is implemented differently around the world – while some jurisdictions have incorporated the *Shariah* approval process into the regulatory framework, others have opted for an informal process which is not subject to any level of regulation by the authorities. (See discussion in the section on *Shariah* Compliance and Convergence).

However, individual IOSCO members may conclude that, for their own policy reasons, a Muslim investor and indeed any investor who chooses to invest in Islamic capital market products, requires some level of assurance that the investment product being purchased meets with *Shariah* principles.

The pertinent IOSCO principle states that:

> Investors should be provided with the information necessary to make informed investment decisions on an ongoing basis. The principle of full, timely and accurate disclosure of current and reliable information material to investment decisions is directly related to the objectives of investor protection and fair, efficient and transparent markets.

An issue raised by the study is whether it is desirable to develop best practices or specific regulatory guidelines to ensure that disclosures made in the offer document accord the investor with full information regarding the *Shariah* compliance of the investment as a means of complying with IOSCO's Objectives and Principles relating to disclosures. Central to this may be the integrity and reliability of the *Shariah* approval process and the credibility of such approval processes. This includes

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[24] Prospectus dated 28 May 2003 in relation to the Public Mutual Equity Fund, approved by the Securities Commission of Malaysia

determining whether the information is "material information" and "relevant to an investment decision." If interpreted as such, the general disclosure requirements can therefore be applied to the offer documents or similar documents in relation to *Shariah* compliance. This would imply a need to ensure that the duties and liabilities of advisers and officers of the issuer with regards to their exercise of due diligence in the provision of this additional information is appropriately regulated.

Generally, non-financial statement disclosures are still voluntary. However, there is a trend towards requiring and increasing the extent of non-financial statement disclosures to ensure that the investor receives adequate information. Within this context, individual IOSCO members may wish to consider encouraging disclosures in relation to meeting the specific investment needs of investor groups; be they ethical investors or Islamic investors.

Furthermore, it should be noted that the requirement for *Shariah* compliance is a continuous process. It is possible that the business activities of the issuer may change over time, e.g., arising out of mergers and acquisitions, and result in a company or investment product no longer being *Shariah* compliant. For this purpose, *Shariah* assessments need to be conducted continuously.

It should be noted that if the nature of a company, an activity or asset changes in nature to the point of being non-*Shariah* compliant, the impact of non-*Shariah* compliance will extend to all other related products of the company such as debt, collective investment schemes and structured products.

With regards to accounting and auditing standards, the main issues in the IOSCO Principle are, among others:

- Comparability and reliability of information;
- Internationally acceptable standards; and
- Quality of accounting and auditing standards.

While findings from the survey indicated that the application of accounting standards and practices for Islamic capital market transactions are not uniform across jurisdictions, it did reveal a common approach among Islamic financial institutions to apply IASs for financial reporting. However, the survey also revealed initiatives by several jurisdictions to formulate and adopt accounting standards that are tailored specifically for Islamic capital market transactions.

The challenge to formulating a robust financial reporting framework for the Islamic financial services industry arises from the fact that Islamic finance is still undergoing substantial development and innovation. The current approach to developing financial standards for Islamic transactions is to benchmark against international standards such as International Accounting Standards (IASs) to ensure consistency with globally accepted standards and modifying them, where necessary, in order to ensure financial statements present fairly the financial position, financial performance and cash flows of the Islamic financial institution.

This can be seen as a response to the growth and increasing maturity of the Islamic capital market that requires more specific disclosure and standards that address the specific features of Islamic products and services. Hence, international Islamic financial institutions such as AAOIFI have begun to set international Islamic accounting standards for Islamic financial institutions which are likely to be used by the global Islamic financial services industry. Four countries, namely Jordan, Sudan, Qatar and Bahrain, at the point of this report, have adopted the application of AAOIFI standards. However, IASs continue to be applied in areas that are not covered by AAOIFI accounting standards. Malaysia, on the other hand, through the Malaysian Accounting Standards Board, is formulating its own national Islamic accounting standards that are to be applied by its domestic Islamic financial institutions. In formulating the standards, the Malaysian accounting standard-setting body has given consideration to the substance of the AAOIFI and IASs.[25]

[25] The Malaysian Accounting Standards Board (MASB) is established under the Financial Reporting Act 1997 as an independent authority to develop and issue accounting and financial reporting standards in Malaysia. At present, MASB issued its first standard on Islamic financial services industry, namely MASB *i*-1: Presentation of Financial Statements of Islamic Financial Institutions.

Survey respondents generally indicate that the convergence between national Islamic accounting standards and international Islamic accounting standards is very important to facilitate the development of globally accepted and tradable Islamic capital market products and services. The convergence will promote the comparability of financial information released by Islamic financial institutions in different jurisdictions around the world.

The auditing profession also faces challenges in developing the necessary expertise to conduct audits on Islamic financial institutions and intermediaries. In addressing this issue, AAOIFI has issued international Islamic auditing standards for Islamic financial institutions. Thus, individual IOSCO members may wish to consider adding requirements relating to the responsibility of auditors to provide reasonable assurance that Islamic capital market transactions and products comply with *Shariah* principles, in addition to complying with the relevant accounting standards and practices adopted in the jurisdiction in which the institution operates.

A-1.4 *Principles for Collective Investment Schemes*

Among the areas highlighted within the IOSCO principles, which are pertinent to Islamic collective investment schemes, are as follow:

- Competence to carry out the functions and duties of a scheme operator;
- Operator specific powers and duties; and
- Internal management procedures.

Furthermore, the principles also require that "matters material to the value of the scheme are the subject of disclosure to investors and potential investors." The principle states:

> Disclosure about a collective investment scheme should assist investors in understanding the nature of the investment vehicle and the relationship between risk and return, so that investors evaluating scheme performance do not focus solely on return but also the risk

> assumed to produce the return. However, investors should be free to choose the level of risk to which they are exposed. There should be clear disclosure of investment policies.

Furthermore:

> Supervision of an operator of a collective investment scheme should ensure that the stated investment policy or trading strategy of the scheme or any policy required under regulation has been followed and that any restrictions on the type or level of investment have been complied with.

Individual IOSCO members may wish to consider a number of issues concerning collective investment schemes relating mainly to disclosure and accounting treatment as a result of the *Shariah*-compliant nature of the product. The basic principle to which the collective investment scheme adheres to is stated in its memorandum and articles of association and its investment mandate. This would include the *Shariah* principles, which would determine the investment criteria of the products. Related to this, the fund would need to rely on a system to ensure that its investment activities are and remain *Shariah* compliant. This system could be constructed in-house or provided by an external *Shariah* expert who would provide regular updates to the fund as to the *Shariah* compliance of the various investment products on an on-going basis. Disclosures in relation to this are critical for an investor to be fully informed of the product and to ensure that the investor receives a product that is true to its label. This may be particularly relevant in jurisdictions where the *Shariah* approval process or the need for a *Shariah* Board is not embedded within the regulatory framework.

There are current issues being debated in relation to the relevant knowledge and skills of the fund manager, both in determining the investable products as well as in ensuring that the collective investment scheme is managed and administered according to *Shariah* principles. Malaysia, for instance, has introduced specific guidelines on *Shariah* funds requiring the *Shariah* advisor as well as the compliance officer to be well versed both in the area of fund management as well as in *Shariah* principles. Furthermore, the guidelines require the scheme to make a disclosure as to

how it has complied with *Shariah* principles during the year. Trustees of the fund are also under an obligation to ensure that *Shariah* aspects of the scheme are complied with. Comments from international market practitioners on this regulation have been positive, as they believe such regulation ensures that the investment policy and any restrictions to which the scheme is subject are complied with and communicated to investors. More importantly, it clarifies the duties of a collective investment scheme operator to its clients and enhances investor rights in relation to the scheme.

As mentioned earlier, another point that should be noted is the risks to *Shariah* funds arising from the change in the *Shariah* status of the assets that it has invested in. Requirements for disclosures outlining the process to manage such risks should routinely be provided to investors.

A-1.5 *Principles for Market Intermediaries*

As mentioned in Chapter Three, Islamic capital market stockbroking activities have been developed in jurisdictions such as Malaysia, Kuwait and the United Kingdom. While the activities are regulated within the same institutional and regulatory framework as that of conventional stockbroking, the additional requirement is in relation to the *Shariah*-compliant nature of their activities. Similarly, while licensing and supervision functions of the regulator remain the same as those applied to conventional market intermediaries, individual IOSCO members may wish to give attention to the manner in which reporting is conducted, particularly financial reporting of their Islamic activities. They may also wish to consider the manner in which the operations of Islamic windows are reflected within a consolidated account, to ensure a clear demarcation in the reporting for Islamic and non-Islamic financial activities of the intermediary.

Intermediaries can also provide *Shariah*-compliant margin-financing services to the clients. In many cases, this would be structured as a *murabahah* instrument. Risks related to these types of financing should be carefully evaluated and consideration should be given as to whether this should be reflected in its capital requirements or mitigated in other ways.

Another important issue is the need to enhance knowledge, skills and professionalism of front-line individuals such as brokers and advisors in providing investment advice to investors. This raises an additional question for Islamic intermediaries, which is whether requirements for *Shariah* expertise should be considered in tandem with other factors such as educational qualification and industry experience by investors when choosing their Islamic investment advisor. Equally important is the internal policies developed by the market intermediaries. Gaps in these areas may result in a shortfall in meeting the need to protect investor interests.

B. *Shariah* compliance and convergence

Certainly, *Shariah* compliance is the key distinguishing feature of the Islamic capital market. In order to be deemed as *Shariah*-compliant, Islamic capital market products and services need to undergo a pre-defined vetting and approval process by *Shariah* advisers. Survey respondents recognised the importance of having an appropriate *Shariah* approval process. In addition, some survey respondents also indicated the need to have formal regulatory requirements for the establishment of *Shariah* advisory bodies to act as central reference points in assessing *Shariah* compliance of Islamic capital market products and services.

While some jurisdictions have established regulatory requirements for the appointment of *Shariah* advisory bodies, the survey findings indicate that there is presently no standardised requirement across jurisdictions with Islamic capital market activities in respect of the eligibility and qualification of the *Shariah* advisors.

The survey responses also revealed that the *Shariah* approval process or certification process is carried out through two different methods. The first is through a market approach whereby financial institutions have their own in-house independent *Shariah* advisory bodies that screen and endorse their Islamic capital market products and services. Seventeen out of the 24 survey respondents, which reported to have Islamic capital market activities in their jurisdictions, stated that the *Shariah* certification process is undertaken by private sector in-house *Shariah* advisory bodies. This

process is driven by private sector-led initiatives, and is not mandated by any specific regulatory or policy requirement.

The second method takes an approach whereby the regulatory authority assesses *Shariah* compliance and issues the appropriate *Shariah* certification for all Islamic capital market products and services under its purview. The other four jurisdictions (Malaysia, Indonesia, Sudan and Pakistan) use this approach as the *Shariah* certification process is undertaken at the regulator's level, whereby the regulatory authorities have established their own *Shariah* advisory bodies, to formally advise the relevant regulatory authorities on issues pertaining to Islamic capital market products and services. *Shariah* compliance issues are taken into consideration in the regulator's functions such as product approval, eligibility criteria for intermediaries, reporting requirements of regulated entities, and enforcement of regulatory requirements.

There also appears to be jurisdictions where no formal *Shariah* certification process exists, whether in the private sector or at the regulatory level. This situation demonstrates again the lack of a uniform approach in addressing regulatory issues concerning Islamic capital market products and services.

The methods of *Shariah* certification in the jurisdictions of survey respondents are shown in table 4.3.2-2.

Table 4.3.2-2 *Shariah* certification process

No	*Shariah* certification done at regulator level	*Shariah* certification done at industry level	No *Shariah* certification
1.	Indonesia	Australia	Korea
2.	Malaysia	Bahrain	Nigeria
3.	Sudan	Bangladesh	Turkey
4.	Pakistan	Bosnia	
5.		Ontario, Canada	
6.		Dubai	
7.		India	
8.		Jordan	
9.		Labuan	

No	*Shariah* certification done at regulator level	*Shariah* certification done at industry level	No *Shariah* certification
10.		Qatar	
11.		South Africa	
12.		Singapore	
13.		Sri Lanka	
14.		Thailand	
15.		United Arab Emirates	
16.		United Kingdom	
17.		United States	
	4	**17**	**3**

Individual IOSCO members may wish to consider whether a greater level of clarity and understanding should be made available to market participants regarding this issue to ensure that the *Shariah* compliance aspects of Islamic investments are adhered to. Whilst it is noted that this is an area that is still developing, regulators and/ or practitioners involved in Islamic capital markets may wish to consider best practices with regards to the *Shariah* certification process.

Feedback from respondents also indicates that there is lack of convergence of *Shariah* interpretations. The survey showed that different jurisdictions have adopted different practices in relation to various Islamic capital market products and services. This is a result of the varying interpretation on various *Shariah* issues across jurisdictions, which is rooted in the different schools of thought among *Shariah* scholars.

This may have implications for cross border flows in relation to investment and trading of international Islamic instruments. Some survey respondents and industry practitioners suggest that the convergence of interpretations will facilitate higher levels of issuance of globally accepted Islamic capital market products and services in the international market. Arguably, the convergence and harmonisation of *Shariah* interpretations could lead to the creation of more homogeneous Islamic capital market products and services that in turn will increase investors' demand and enhance the overall growth of the Islamic capital market. For instance, the Malaysian and Qatar Global Islamic Bonds (*Sukuk*) are two examples of Islamic products that are globally accepted, having satisfied all varying *Shariah* compliance requirements, and are listed

on several global exchanges. Differing *Shariah* interpretations may also impact the enforceability of a transaction, as differences in interpretation would affect the recognition of legal rights and liabilities of parties to a transaction, particularly in cross-border situations.

C. Comprehensive range of products

Feedback from respondents indicated that there is increasing worldwide demand from the investing public, international institutions and corporations for Islamic capital market products and services. This demand is driven by an increasing number of Muslim investors who are looking for products and modes of investment that are acceptable and in compliance with the *Shariah*. Within this context, Islamic capital market products also share much in common with another trend, that is, the preference for ethical investing. The commonality exists because Islamic capital market products, being *Shariah*-compliant, may be viewed as having ethical underpinnings by virtue of the prohibition of involvement with, among others, alcohol, tobacco and gambling.

Nevertheless, individual IOSCO members may conclude that the pace of the development of Islamic capital market products and services is insufficient to ensure an adequate supply of products to satisfy the growing appetite for Islamic products. This was confirmed by the survey, which indicated that there is an inadequate supply of Islamic capital market products and services offered to satisfy the different needs of issuers, investors and other market participants. The consequential effect of this demand-supply mismatch results in a higher cost to investors keen to invest in Islamic capital market products and services.

Therefore, individual IOSCO members, as a matter of policy, may conclude that there is a need to further accelerate product innovation in the Islamic capital market. An expansion in the range of products would cater to the different risk-return requirements of investors and provide attractive alternatives to conventional capital market products and services. The range of *Shariah*-compliant fixed income and risk management products including derivative products should be expanded for capital raising requirements as well as for private asset allocation, hedging and diversification

needs. The pioneering efforts by Saudi Economic and Development Company (SEDCO) to introduce Islamic hedge funds can be seen as steps towards filling the vacuum in product availability. In addition, the effort to introduce Islamic capital market products which offer floating rates is another potential development path that can be explored. At present, almost all Islamic capital market products offer fixed rate returns based on the deferred-payment sale (*bai` bithaman ajil*) and cost-plus sale (*murabahah*) concepts. As such, the leasing (*ijarah)* concept that has been applied in structuring Islamic global bonds can be utilised in structuring new Islamic products that offer floating rate returns. In addition, the existence of a reliable market-based benchmark yield curve for Islamic bonds is crucial, as this would facilitate the price-discovery process of Islamic bonds and enhance the efficient pricing of Islamic bonds issues.

Individual IOSCO members may also wish to intensify the development of secondary market liquidity for Islamic financial instruments. Currently, the secondary market for Islamic products tends to be shallow and illiquid due to the insufficient supply of tradable Islamic products as well as the typical buy-and-hold approach of investing institutions. This behaviour is, in turn, influenced by the scarcity of attractive Islamic instruments. Therefore, there is a need to accelerate and intensify the issuance of Islamic products on the various international financial exchanges such as in Labuan, Bahrain and Luxembourg to meet the liquidity requirements of Islamic financial institutions and investors. The introduction of Islamic global depository receipts (IDR) could be considered as a potential approach of creating liquidity in the Islamic capital market.

D. Cost efficiency and tax framework

Another significant finding from the survey is the importance attached to the cost competitiveness of Islamic capital market products and services. The challenge for Islamic capital market intermediaries is to ensure that the associated costs of issuing and trading Islamic capital market products and services are comparable to conventional products.

Within the context of cost-competitiveness, one major factor that impacts on costs is the appropriate tax framework for Islamic capital market transactions. It should be noted that the tax treatment for certain Islamic capital market transactions is dissimilar with that of conventional transactions. As mentioned in the previous chapter, some of the Islamic capital market transactions involved the sale and purchase of an underlying asset (e.g. properties). It was recognised that the unique underlying structure of Islamic transactions inadvertently triggers taxes such as a real property gains tax, income tax and double stamp duty. The tax framework's structure should ensure that there is tax neutrality between Islamic and conventional capital market products. Without a specific tax framework for Islamic capital market transactions, product development and innovation would be impeded, and participation in Islamic capital market transactions may also be discouraged. Within many of the jurisdictions practising Islamic finance, the nature of Islamic transactions have been recognised and the relevant tax authorities have accordingly structured their tax frameworks to reflect that Islamic transactions are actually financing in nature, and therefore should be treated on a similar basis as conventional financing. Therefore, individual IOSCO members may wish to consider addressing specific tax issues pertinent to Islamic capital market products and services in order to eliminate inconsistencies and uncertainties in the tax treatment between Islamic and conventional capital market transactions.

In Malaysia, the effort to introduce comprehensive tax treatments for Islamic capital market transactions was reflected in the Federal Budget 2004 which addressed such anomalies in order to provide similar tax treatment and therefore promote a level playing field with conventional capital market transactions.

The same approach has also recently been adopted by the government in the United Kingdom when the Chancellor of the Exchequer announced in the 2003 Budget changes to the stamp duty regime that would have the effect of removing the additional stamp duty on Islamic mortgages.

Although initial progress has been made to address the tax treatment on Islamic financial transactions in Malaysia and the United Kingdom, other jurisdictions that

offer Islamic capital market products and services may wish to consider measures to help ensure tax neutrality with conventional capital market products and services.

E. Market professionals

Respondents to the survey indicated a clear need for market professionals to have sufficient technical knowledge on the Islamic capital market as well as knowledge in *Shariah* principles to provide the necessary range of high quality, advisory and intermediation services.

Respondents indicated that there are presently insufficient numbers of professionals who are well versed in both the capital market and *Shariah* knowledge. This is due to the relatively short supply of training and professional courses on the Islamic capital market. This, in turn, has constrained product development and the availability of services to investors in relation to the Islamic capital market.

Hence, individual IOSCO members may wish to consider an expansion of the pool of Islamic capital market experts covering subject matters such as corporate finance, legal, accounting and tax as well as the *Shariah*. Intensified efforts are required to promote greater dialogue between *Shariah* scholars and market professionals, which can be reinforced by encouraging greater research on Islamic finance. In addition, educational institutions like universities, colleges and private training providers may wish to increase the supply of relevant courses while financial institutions could also take the initiative to offer in-house courses and professional training modules on the Islamic capital market. Apart from that, greater collaboration between global institutions and training providers could also be beneficial in providing and organising training programmes on the Islamic capital market.

F. Investor education

Another equally important consideration relates to the level of awareness and understanding of investors with regards to Islamic capital market products. Investor education is critical to improving investor activism as well as enhancing investor protection and scrutiny of Islamic capital market activities. Discerning investors

typically demand higher standards of service, and this in turn would contribute to the development of higher standards being applied by market practitioners.

G. Knowledge sharing

The respondents to the survey were of the view that there is a need to improve the process of data collection in relation to the Islamic capital market. The creation of a comprehensive database, which is accessible to the general public, would be valuable in facilitating research and benchmarking activities concerning the Islamic capital market. At present, the databases for the Islamic capital market are very limited and difficult to obtain especially in terms of obtaining statistical data on the size and profile of the products and services in various jurisdictions. The existing databases are largely driven by the private sector for their clients and business purposes, such as those developed by Failaka International. Other sources of data can be found through magazines such as Islamic Banker and New Horizon. These create difficulty for interested parties such as researchers, market players and regulators to assess relevant information in order to monitor and assess the Islamic capital market.

4.4 Survey highlights

The results of the survey and following studies revealed several challenges and gaps that need to be addressed regarding the development of the Islamic capital markets. Individual IOSCO members may conclude that certain pre-requisites such as a sound regulatory framework, a robust accounting framework, a facilitative tax environment and an appropriate *Shariah* compliance process must be in place in order for there to be a fair, efficient and transparent Islamic capital market.

A significant finding from the survey was the consensus view that the conventional securities regulation framework and principles equally apply to the Islamic capital market, with the addition of some form of a *Shariah* approval or certification process. This augurs well for the growth of the Islamic capital market as it implies that there is no need to formulate separate regulatory principles for the Islamic capital market. By extension, IOSCO's objectives and principles of securities regulation can be applied to the Islamic capital market. Within this context, the Islamic capital market may be

perceived as a class of products within the wider securities market. However, some jurisdictions have suggested that specialised regulation for Islamic capital markets may be necessary and, from their perspective, this may require more in-depth examination of the specific regulatory requirements.

The survey also highlighted several gaps and concerns such as the divergent *Shariah* interpretations, the lack of available and easily accessible data on Islamic capital market statistics and a shortage of market professionals well versed in both Islamic finance and *Shariah* principles. Addressing these concerns may require international cooperation and dialogue among interested IOSCO members. Securities regulators involved in Islamic capital markets and other international Islamic financial institutions like AAOIFI and IFSB, are well-positioned to play a significant role in facilitating the exchange of views and to spearhead the formulation of potential recommendations with the aim of assuring that regulations developed for the Islamic capital markets are compliant with IOSCO's Objectives and Principles.

Chapter 5: Conclusion

This report has presented the landscape of the Islamic financial services industry and discussed the role of the Islamic capital market within the broader Islamic financial services industry. The report has also presented its findings surfaced from a survey conducted with IOSCO members and selected external parties familiar with Islamic financial products and services. The objective of the report is to provide an informative discussion of the state of the Islamic financial services industry in general, and to assess the extent to which Islamic capital market products and services are offered in various jurisdictions, as well as to identify any potential regulatory issues arising specific to Islamic capital markets.

In mandating the Task Force to undertake this fact-finding study, IOSCO has taken an important step towards assessing the extent of the development of the Islamic capital market and understanding the issues it faces. The key issues that have surfaced point to the conclusion that the Islamic capital market constitutes a segment of the wider global securities market, the regulation of which should comply with IOSCO's Objectives and Principles. The consensus view that emerged clearly indicates that a capital market with a sound, regulatory framework and appropriate supporting infrastructure must first be present in order to nurture and support an Islamic capital market component. This finding is significant as it postulates that Islamic capital market products and services may be introduced and developed within any existing well-structured securities market.

While conventional principles of securities regulation may be applied to the Islamic capital market, there may in certain instances in which individual jurisdictions perceive a need for more specific guidelines to be introduced to ensure that the unique aspects of Islamic capital market products are appropriately regulated. These members may wish to pursue a series of issues. Domestically, some jurisdictions have begun developing specialised guidelines for Islamic capital markets. However, the report shows that there are currently no global best practices for regulation concerning significant areas such as *Shariah* certification, the establishment of

Shariah boards, qualifications of *Shariah* advisors and enhanced disclosure relating to Islamic capital market products. The report noted that there are views that a level of uniformity in regulation and practices of this market sector would need to be achieved to provide further clarity to market practitioners and to allow investor demands to be met effectively. Uniformity on the basis and foundations of regulatory approaches would allow for enhanced investor understanding of products, thus encouraging further cross-border activity in this market segment.

Similarly, it was found that investors' accessibility to information is also critical to this market segment. This relates to both the availability of information on investable products on a wider basis, as well as the credibility and quality of the information provided. These issues would require careful consideration for the orderly development of the Islamic international financial market and for the protection of investors.

Divergent *Shariah* interpretations is another issue faced by the Islamic financial services industry, and is seen by some to have an impact on the development of globally acceptable financial products and growth of the Islamic financial services industry. Through its survey and research, the Task Force has found that some Islamic financial market participants believe benefits could be derived from a convergence of *Shariah* interpretations. As such, the issue of convergence is perhaps a long term developmental objective that would need to be spearheaded by Shariah scholars themselves. The report stresses that international cooperation and collaboration is necessary for the Islamic capital market to make inroads towards resolving these issues.

Another challenge, the skills gap of market practitioners, is also a critical area which requires attention to enable the sustainable growth of this market segment.

On the international regulatory level, there are various organisations that have been established in relation to the Islamic financial services industry. These include AAOIFI, IFSB and IIFM. Understandably, with Islamic banking being the most developed segment of the Islamic financial services industry, these international organisations are focused on Islamic financial institutions. There is to date, no

international body, which provides a platform of debate and direction with a focus on Islamic capital market issues. Clearly, there is a gap in the international regulatory arena concerning Islamic capital market issues, which may benefit from implementation of the relevant IOSCO Objectives and Principles regarding international co-operation and dialogue.

Several of these Islamic international organizations have begun to look into and consider regulatory and accounting issues relevant to Islamic finance. IOSCO may have a role in contributing to these international deliberations, particularly in providing its views and guidance on matters such as investor protection and international enforcement co-operation, as well as its expertise in market regulation. This interaction is imperative to ensure that any pronouncements affecting the Islamic capital market are developed consistently with IOSCO's Objectives and Principles.

This report is meant to provide an impetus towards further discussion on Islamic capital markets. Given the increasing inter-connectivity of markets as well as the technical expertise and knowledge IOSCO members can bring into the discussion, IOSCO, as the world's most important international cooperative forum for securities regulatory agencies, is well positioned to contribute towards any Islamic capital market issue that may have an impact on the regulation of global securities markets.

Annex 1

Members of the IOSCO Islamic Capital Market Task Force

Chairman

Securities Commission, Malaysia	Ali Abdul Kadir (until 29 February 2004) Md Nor Md Yusof (from 1 April 2004)

Members

Australian Securities and Investments Commission	Mark McGinness
Indonesian Capital Market Supervisory Agency	Herwidayatmo Indra Surya
Jordan Securities Commission	Dr. Bassam Saket
Securities Commission, Malaysia	Zarinah Anwar Ranjit Ajit Singh Kamarudin Hashim Shareena Sheriff
Securities and Exchange Commission, Nigeria	Suleyman Ndanusa Daisy Ekineh
Financial Services Board, South Africa	Jeff van Rooyen
Office of the Securities and Exchange Commission, Thailand	Rashnee Smuthranond
Capital Markets Board, Turkey	Dogan Cansizlar

Correspondent members

Commissione Nazionale per le Società e la Borsa, Italy	Carlo Biancheri
Financial Services Authority, United Kingdom	Toby Fiennes
Securities and Exchange Commission, United States	Robert J. Peterson

Secretariat

Securities Commission, Malaysia

Annex 2

Glossary of Islamic capital market terms

TERMS	DEFINITION
Bai` Bithaman Ajil (BBA)	A contract that refers to the sale and purchase transaction for the financing of assets on a deferred and an instalment basis with a pre-agreed payment period. The sale price will include a profit margin.
Bai` al-`Inah	A contract, which involves the sale and buy back transaction of assets by a seller. A seller will sell the asset to a buyer on a cash basis. The seller will later buy back the same asset on a deferred payment basis where the price is higher than the cash price. It can also be applied when a seller sells an asset to a buyer on a deferred basis. A seller will later buy back the same asset on a cash basis at a price, which is lower than the deferred price.
Bai` al-Istijrar	A contract between the client and the supplier, whereby the supplier agrees to supply a particular product on an on going basis, for example monthly, at an agreed price and on the basis of an agreed mode of payment.
Bai` al-Dayn	A transaction that involves the sale and purchase of securities or debt certificates that conforms with *Shariah*. Securities or debt certificates will be issued by a debtor to a creditor as evidence of indebtedness.
Bai` al-Muzayadah	An action by a person to sell his asset in the open market, which is accompanied by the process of bidding among potential buyers. The asset for sale will be awarded to the person who has offered the highest price. In other words, it is known as the sale and purchase transaction based on tender.
Bai` al-Salam	A contract whereby the payment is made in cash at the point of contract but the delivery of asset purchased will be deferred to a pre-determined date.
Bai` al-Wafa'	A contract with the condition that when the seller pays back the price of the goods sold, the buyer returns the goods to the seller.
Dhaman	A contract of guarantee whereby a guarantor shall underwrite any claim and obligation that should be fulfilled by an owner of the asset. This concept is also applicable to a guarantee provided on a debt transaction in the event a debtor fails to fulfil his debt obligation.
Gharar	*Gharar* is an element of deception either through ignorance of

TERMS	DEFINITION
	the goods, the price, or through faulty description of the goods, in which one or both parties stand to be deceived through ignorance of an essential element of exchange. As an example, gambling is a form of *Gharar* because the gambler is ignorant of the result of the gamble. *Gharar* is divided into three types, namely *gharar fahish* (excessive), which vitiates the transaction, *gharar yasir* (minor), which is tolerated and *gharar mutawassit* (moderate), which falls between the other two categories. Any transaction can be classified as forbidden activity because of excessive *gharar*.
Haq Maliy	*Haq maliy* are rights on the financial assets. Examples of such rights are *haq dayn* (debt rights) and *haq tamalluk* (ownership rights).
Hibah	A gift awarded to a person.
Hiwalah	A contract that allows a debtor to transfer his debt obligation to a third party.
Ibra'	An act by a person to withdraw his rights, i.e., his rights to collect payment from a person who has the obligation to repay the amount borrowed from him.
Ijarah	A *manfaah* (usufruct) type of contract whereby a lessor (owner) leases out an asset or equipment to his client at an agreed rental fee and pre-determined lease period upon the *aqad* (contract). The ownership of the leased equipment remains in the hands of a lessor.
Ijarah Thumma Bai`	A contract which begins with an *Ijarah* contract for the purpose of leasing the lessor's asset to the lessee. Consequently, at the end of the lease period, a lessee will purchase the asset at an agreed price from a lessor by executing a purchase (*Bai`*) contract.
Istisna`	A purchase order contract of assets whereby a buyer will place an order to purchase an asset that will be delivered in the future. In other words a buyer will require a seller or a contractor to deliver or construct the asset that will be completed in the future according to the specifications given in the sale and purchase contract. Both parties to the contract will decide on the sale and purchase prices as they wish and the settlement can be delayed or arranged based on the schedule of the work completed.
Ittifaq Dhimni	This is an external agreement, which must be reached before the contract can be concluded to allow for the bidding process (*Bai` al-Muzayadah*) to take place.

TERMS	DEFINITION
Ji`alah	Contract of reward; a unilateral contract promising a reward for a specific act or accomplishment.
Kafalah	It has the same meaning as *Dhaman*.
Khilabah	A form of fraud, either in word or deed by a party to the trading contracts with the intention of inducing the other party into making a contract. This is prohibited according to *Shariah*.
Khiyanah	Refers to deception by not disclosing the truth or breaching an agreement in a hidden way. This is prohibited according to *Shariah*.
Mal	Something that has value and can be gainfully used according to *Shariah*.
Maisir	Any activity that involves betting whereby the winner will take all the bets and the loser will lose his bet. This is prohibited according to *Shariah*.
Mudharabah	A contract, which is made between two parties to finance a business venture. The parties are a *rabb al-mal* or an investor who solely provides the capital and a *mudarib* or an entrepreneur who solely manages the project. If the venture is profitable, the profit will be distributed based on a pre-agreed ratio. In the event of a business loss, the loss shall be borne solely by the provider of the capital.
Murabahah	A contract that refers to the sale and purchase transaction for the financing of an asset whereby the cost and profit margin (mark-up) are made known and agreed by all parties involved. The settlement for the purchase can be settled either on a deferred lump sum basis or on an instalment basis, and is specified in the agreement.
Musharakah	A partnership arrangement between two parties or more to finance a business venture whereby all parties contribute capital either in the form of cash or in kind for the purpose of financing the business venture. Any profit derived from the venture will be distributed based on a pre-agreed profit sharing ratio, but a loss will be shared on the basis of equity participation.
Muqasah	Debt settlement by a contra transaction.
Qabdh	*Qabdh* means possession, which refers to a contract of exchange. Generally, *qabdh* depends on the perception of *'urf* or the common practices of the local community in recognising that the

TERMS	DEFINITION
	possession of a good has taken place.
Qardh Hasan	A contract of loan between two parties on the basis of social welfare or to fulfil a short-term financial need of the borrower. The amount of repayment must be equivalent to the amount borrowed. It is however legitimate for a borrower to pay more than the amount borrowed as long as it is not stated or agreed at the point of contract.
Rahn	An act whereby a valuable asset is used as collateral for a debt. The collateral will be utilised to settle the debt when a debtor is in default.
Riba	An increase, which in a loan transaction or in exchange of a commodity, accrues to the owner (lender) without giving an equivalent counter value or recompense in return to the other party. It covers interest both on commercial and consumer loans, and is prohibited according to *Shariah*.
Sarf	A buying and selling of currencies.
Suftajah	A credit instrument issued to a creditor to enable him to use or cash it at another predetermined venue and at the future date.
Sukuk	A document or certificate, which evidences the undivided pro-rata ownership of underlying assets - the *Sak* (singular of *Sukuk*) is freely tradable at par, premium or discount.
Shariah	Islamic law, originating from the *Qur`an* (the holy book of Islam), as well as practices and explanations rendered by the prophet Muhammad (*pbuh*) and *ijtihad* of ulamak (personal effort by qualified *Shariah* scholars to determine the true ruling of the divine law in a subject matter on which the revelation is not explicit).
Tadlis al-`aib	Refers to the activity of a seller intentionally hiding the defects of goods. This activity is prohibited according to *Shariah* principles.
Takaful	This is a form of Islamic insurance based on the principle of *ta'awun* or mutual assistance. It provides mutual protection of assets and property and offers joint risk sharing in the event of a loss by one of its members. Takaful is similar to mutual insurance in that members are the insurers as well as the insured.
Tanajush	Refers to a conspiracy between a seller and a buyer wherein the buyer is willing to purchase the goods at a higher price. This is done so that others would rush to buy the goods at a higher

TERMS	DEFINITION
	price, resulting in the seller obtaining a huge profit. This transaction is not permissible in Islam.
Ta`widh	Penalty agreed upon by the contracting parties as compensation that can rightfully be claimed by the creditor when the debtor fails or is late in meeting his obligation to pay back the debt.
Ujrah	Financial payment for the utilisation of services or *manfaa*t. In the context of today's economy, it can be in the form of salary, wage, allowance, commission and the like.
`Urbun	A deposit or earnest money which forms part payment of the price of goods or services paid in advance, but will be forfeited in the event the transaction is cancelled. The forfeited money is considered as *hibah* (gift).
'Uqud al-Mu'awadat	Contracts of exchange.
'Uqud al-Tabarruat	Charitable contract.
'Uqud al-Ishtirak	Contract of partnership
Wakalah	A contract, which gives the power to a person to nominate another person to act on his behalf as long as he is alive based on the agreed terms and conditions.
Wadiah Yad Dhamanah	Goods or deposits, which have been deposited with another person, who is not the owner, for safekeeping. As *wadiah* is a trust, the depository becomes the guarantor and, therefore guarantees repayment of the whole amount of the deposits, or any part thereof, outstanding in the account of depositors, when demanded. The depositors are not entitled to any share of the profits but the depository may provide returns to the depositors as a token of appreciation.
Zakat	A tax, which is prescribed by Islam on all persons having wealth above a certain amount and that is fixed by the *Shariah*. According to the Islamic belief Zakat purifies wealth and souls. The objective is to take away a part of the wealth of the well-to-do and to distribute it among the 8 categorises stated in the Quran.

Annex 3

Respondents to the IOSCO Islamic Capital Market Task Force survey

No.	Respondent
1.	Comision Nacional de Valores, Argentina
2.	Australian Securities and Investments Commission
3.	Bahrain Monetary Agency
4.	Securities and Exchange Commission, Bangladesh
5.	Securities Commission of the Federation of Bosnia & Herzegovina
6.	Ontario Securities Commission, Canada
7.	Dubai International Financial Centre
8.	Securities and Exchange Board of India
9.	International Monetary Fund
10.	Indonesian Capital Market Supervisory Agency
11.	Commissione Nazionale per le Societa e la Borsa, Italy
12.	Jordan Securities Commission
13.	Financial Supervisory Service, Korea
14.	Labuan Offshore Financial Services Authority
15.	Securities Commission, Malaysia
16.	Securities and Exchange Commission, Nigeria
17.	Securities and Exchange Commission, Pakistan
18.	Commissao do Mercado de Valores Mobiliarios, Portugal
19.	Qatar Central Bank
20.	Monetary Authority of Singapore
21.	Financial Services Board, South Africa
22.	Amana Investment Ltd, Sri Lanka
23.	Bank of Sudan
24.	Securities and Exchange Commission, Thailand
25.	Capital Markets Board, Turkey
26.	Central Bank, United Arab Emirates
27.	Financial Services Authority, United Kingdom
28.	Securities and Exchange Commission, United States
29.	Dow Jones
30.	HSBC Amanah Finance, Dubai

Annex 4

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